UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES LITIGATION	§ Civil Action No. H-01-3624 § **(Consolidated)**
This Document Relates To:	§ CLASS ACTION
MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, vs. ENRON CORP., et al., Defendants.	§
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, vs. KENNETH L. LAY, et al., Defendants.	§

OPPOSITION TO MOTIONS TO DISMISS OF THE INDIVIDUAL ANDERSEN DEFENDANTS AND MICHAEL C. ODOM

840

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES **Page**

Page

Page

Page

STATUTES, RULES AND REGULATIONS

I. INTRODUCTION

The Individual Andersen Defendants ("Andersen Partners") urge the Court to accept the notion that, despite having audited and certified Enron's 97-00 financial statements, not a single public representation is attributable to them. It is true the Enron audit reports bear the name Arthur Andersen, but Andersen can act only through its partners. The Andersen Partners provided internal audit and consulting services, and were responsible for the "independent" outside audit of Enron's books. They bear individual responsibility for certifying financial statements known to be false.

Plaintiffs' claims extend beyond the Andersen Partners' fraudulent audit reports. The Andersen Partners participated in a scheme to defraud by structuring, and when necessary restructuring, numerous Special Purpose Entities ("SPEs"), including Chewco, LJM and LJM2, and the Raptors, to conceal Enron's staggering debts and devastating losses from merchant investments. And when the Enron fraud began to unravel, Nancy Temple and others rushed to destroy the incriminating evidence.

The Andersen Partners' own internal memoranda and e-mail support an overwhelming inference of scienter. For example, one month before Enron's 99 financial statements were issued, Carl Bass, a member of Andersen's internal oversight group, warned Neuhausen and Stewart of several Enron transactions involving an SPE–"this whole deal looks like there is no substance." Three days later, Bass criticized another Enron SPE in an e-mail to Stewart for having no real substance and disapproved a transaction in which Enron was set to gain from the appreciation of the capital stock it contributed to the SPE. Partners Bauer and Cash were privy to these conclusions.

Three weeks before Enron's 00 financial statements were certified, partners Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart and Swanson met via conference call to discuss Enron's serious accounting improprieties. A follow-up memorandum from the call reveals the partners identified and discussed numerous irregularities in Enron's accounting. They nonetheless agreed to issue a clean audit opinion because of Enron's potential to grow into a $100 million-a-year client.

The Andersen Partners claim they cannot be held liable as control persons of Andersen. If the engagement team did not exercise control, then who did? In any event, plaintiffs plead in great

detail allegations demonstrating the Andersen Partners' control – and indeed participation – over all aspects of Andersen's involvement in the Enron fraud.

The Andersen Partners' motions to dismiss should be denied.

II. FACTUAL OVERVIEW

Andersen certified that Enron's financial statements for 97-00 comported with GAAP and its audits of Enron's financial statements complied with GAAS. ¶899.[1] With respect to Enron's 00 financial report on Form 10-K, Andersen declared:

> We conducted our audits in accordance with auditing standards generally accepted in the United States....
>
> In our opinion, the financial statements [of the Company] present fairly, in all material respects, the financial position of Enron Corp. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations, cash flows and changes in shareholders' equity for each of the three years in the period ending December 31, 2000, in conformity with accounting principles generally accepted in the United States.

¶903. Andersen issued nearly identical audit reports for 97 (issued 2/23/98), 98 (issued 3/5/99) and 99 (issued 3/13/00). Andersen's reports were false and misleading due to its failure to conduct its audits in compliance with GAAS and because Enron's financial statements were not prepared in conformity with GAAP, as alleged in detail in ¶¶418-611, so that issuing the reports was in violation of GAAS and SEC rules. Andersen knew its reports would be relied upon by investors in Enron securities. With Andersen's consent, the audited financial statements were included in the registration statements, prospectuses, and annual shareholders' reports Enron filed during the Class Period. ¶905. Andersen also reviewed and approved Enron's interim financial reports and press releases, which contained false financial statements. ¶897. As discussed below, Andersen knew the details of Enron's fraudulent transactions and was a participant in the scheme to defraud investors.

A. Year-End 97 Crisis

The alleged fraudulent scheme and course of business involving Enron finds its origin in mid-97 when Enron suffered huge losses on British natural gas and MTBE transactions, which called

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[1] All "¶__" references are to plaintiffs' Consolidated Complaint ("CC") filed 4/8/02. Additionally, all emphasis is added and all citations and footnotes are omitted unless otherwise indicated.

into question its trading and risk management skills. Analysts downgraded Enron's stock and lowered their forecasts of Enron's future earnings growth. Enron's stock lost one-third of its value and Enron's executives' performance-based bonuses were slashed. Enron was determined to halt its stock's decline and push it back to higher levels. Enron knew this could only be accomplished by reporting stronger-than-expected financial results, thus enabling it to credibly forecast stronger future earnings growth. Unfortunately, Enron's actual business operations were not capable of generating such results. ¶8.

To make matters worse, in late 12/97, Enron learned that an entity it had established with an outside investor – Joint Energy Development Incorporated ("JEDI") – and had done transactions with to generate 40% of the profits Enron reported during 97 – had to be restructured, as the outside investor was going to withdraw from JEDI. This created a crisis. Because the outside investor in JEDI had been independent of Enron, JEDI had ***not*** been consolidated into Enron's financial statements, *i.e.*, Enron did deals with JEDI as an independent party, recognized profits and did not carry JEDI's debt on its books. Thus, unless JEDI could be quickly restructured with a new, independent investor, ***Enron would have to wipe out all of the profitable transactions it had done with JEDI in 97 – put JEDI's $700 million debt on Enron's balance sheet – and lose the ability to generate profits from similar such deals with JEDI's successor going forward.*** ¶9.

However, Enron ***could not find a legitimate buyer for the outside investor's interest*** in JEDI. So Enron and Barclays Bank quickly formed a new entity – Chewco – which Enron and an Enron executive (Michael J. Kopper ("Kopper")) controlled, to buy the outside investor's interest in JEDI. Chewco ***did not have an outside equity investor which was an independent third party***. So, Barclays loaned $240 million to Chewco, requiring a guarantee from Enron. Barclays also loaned the money to two straw parties (Little River and Big River) to provide for their purported "equity" investment in Chewco. Because Barclays knew that the purported equity investors in Chewco were, in fact, Enron "strawmen," Barclays required Chewco to support the purported "equity loans" it made to the two "strawmen" via a $6.6 million reserve paid to Barclays! ¶10. Andersen received documentation detailing the $6.6 million reserve. ¶946(b). The reserve cut Chewco's purported 3% contribution of independent "equity" in half. ¶439. As a result, Chewco – and consequently JEDI

– should have been consolidated in Enron's 97-00 audited financial reports, and ***all of Enron's 97 profits from transactions with JEDI should have been eliminated***. ¶¶10, 442.

By the non-arm's-length Chewco transaction at year-end 97, Enron avoided a disaster for Enron by keeping the previously recorded JEDI profits in place, inflating Enron's 97 reported profits and keeping millions of dollars of debt off its books. Chewco was now also positioned to serve as a controlled entity which Enron could use to do non-arm's-length transactions with, creating at least $350 million in phony profits for Enron and allowing Enron to conceal millions of dollars of debt. Between 98 and 01, Enron and Andersen would create other controlled partnerships and entities and use them to generate hundreds of millions of dollars of phony profits while concealing billions of dollars of Enron debt. ¶11.

B. The 97-00 Successes – Enron's Stock Soars

As Enron reported ***better-than-expected year-end 97 financial results***, its stock moved higher. During 98 through mid-01, Enron appeared to evolve into an enormously profitable high-growth enterprise, reaching annual revenues of $100 billion by 00, with annual profits of $1.2 billion, presenting a very strong balance sheet that entitled it to an ***investment grade credit rating***. By 01, Enron had become the seventh largest U.S. corporation and was consistently reporting ***higher-than-forecasted earnings each quarter*** and forecasting ***continued strong growth***. ¶¶12-13. Enron extolled the success, and earning power of its Wholesale Energy trading business ("WEOS"), its retail Energy Services business ("EES") and its Broadband Content Delivery and Access Trading, *i.e.*, intermediation, business ("EBS"). ¶¶2, 14.

Throughout 98 and 99, as Andersen certified Enron's purported reported record profits, Enron in releases, reports and conversations with investors and analysts and Enron's banks – in analyst reports – stated (¶14(a)):

- Enron's strong results were due to the success of all of its business lines.
- Enron had a leading position in each of its businesses. Enron had an extremely strong franchise position.
- Wessex Water would be accretive to Enron's business now and a $20 billion business in five years. Azurix Corp. was becoming a major global water company.

- International projects would drive major earnings growth for Enron. The Dabhol, India power project would contribute to earnings in 99 and beyond.

- WEOS's business remained strong.

- EES was exceeding expectations for contracts and profitability. EES was adding billions in new contracts and would be profitable by 4thQ 00.

- Enron was optimistic about its broadband business. EBS was firing on track.

- Enron's tremendous competitive advantages enabled it to achieve strong EPS growth.

- Enron was very well managed and knew how to manage and mitigate risk. Enron had effectively used off-balance sheet non-recourse financing. Enron had a strong balance sheet. Enron was a master of risk management.

- No other company offered such impressive sustainable growth.

- Enron was hitting on all eight cylinders. Enron's outlook was excellent. Enron was very optimistic.

- Enron was a global powerhouse, with EPS growth to exceed 17%. Enron would maintain strong earnings growth for years.

During 00, as Andersen certified Enron's purported record annual profits, Enron and its banks stated (¶14(b)):

- Enron's strong financial results were due to strong results in all operations.

- Enron had very strong momentum. Its new trends were sustainable and would accelerate.

- Enron's business was booming. All its operations were gaining momentum.

- Investors were about to see breakout performance of EES and rapid growth and development of EBS.

- EES's new contracts and profitability were accelerating. EES had the potential to double Enron's size in a few years.

- EBS broadband trading was accelerating. The market was larger than expected, and would reach $100 billion in a few years with 3%-4% margins.

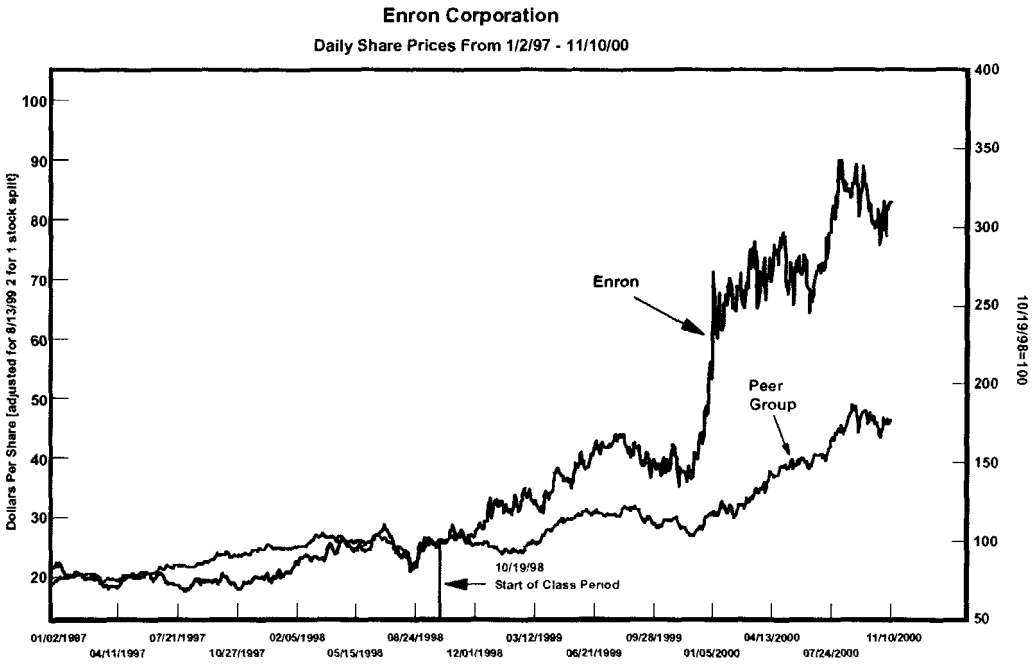
- Enron/Blockbuster video-on-demand ("VOD") deal a "Killer Opp." Unparalleled quality of service. Contract worth over $1 billion. VOD to rollout nationally in 01. All components in place. VOD had solid technology and platform.

- Enron's WEOS merchant investments were protected through hedging.

- Enron had monumental earnings potential over the next five years. Enron was well managed and a pioneer in global energy. Enron was never in better shape. Enron was very optimistic about the continued strong outlook for the Company.

- Growth and strong earnings were why investors should buy Enron stock.

As a result of Enron's strong earnings, the positive statements about its business and the forecasts of continuing strong earnings growth, Enron's stock was a very strong performer and its debt securities also traded at high prices. ¶15. Enron's apparent success and forecasts of strong profit growth gave Enron and its bankers ready access to the capital markets by which they raised billions of dollars by selling newly issued Enron securities to public investors, using the proceeds to repay Enron's bank debt. ¶16. Enron's stock soared to its all-time high of $90-3/4 in 8/00 and then continued to trade at or near these levels for months, as shown below (¶15):



However, the apparent success of Enron was an illusion – a false picture created by manipulative devices and contrivances – a fraudulent scheme and course of business by defendants that operated as a fraud and deceit on the purchasers of Enron's publicly traded securities. The fraudulent scheme was accomplished by, *inter alia*, Andersen and several banks, which pocketed hundreds of millions of dollars a year from Enron – which by 97-98 had become the ***golden goose of Wall Street***. ¶17.

Inside Enron there was a fixation on Enron's stock and doing whatever was necessary to generate the financial results necessary to push the stock ever higher. Throughout Enron's corporate headquarters in Houston were TV monitors that constantly displayed the price of Enron stock. Inside Enron there was a saying that managers were to always be "***ABC***ing," meaning to "***a***lways ***b***e

closing" deals to generate revenues and profits, even if the economics of the deal were suspect – a practice facilitated by a compensation system inside Enron for corporate managers and executives that directly rewarded them financially for ***closing*** transactions and placing a high (*i.e.*, inflated) value on them, regardless of the true economic substance of the deal, so long as the deal generated an apparent profit when "marked to market." ¶50.

Inside Enron, the pressures applied to corporate managers by the top executives to do anything necessary to enable Enron to make its numbers was widespread, as was the knowledge that Enron's revenues and earnings were being falsified at the direction of top executives who rewarded the lower level managers who engaged in such conduct with bonuses in larger amounts to those who were willing to facilitate what had become a Company-wide fraudulent pattern of behavior. Former insiders have been quoted as saying "***[y]ou don't object to anything***" and "***[t]he whole culture at the vice-president level and above just became a yes-man culture.***"

> But that culture had a negative side beyond the inbred arrogance. ***Greed was evident, even in the early days. "More than anywhere else, they talked about how much money we would make," says someone who worked for Skilling. Compensation plans often seemed oriented toward enriching executives rather than generating profits for shareholders. For instance, in Enron's*** energy services division, which managed the energy needs of large companies like Eli Lilly, executives were compensated based on a market valuation formula that relied ***on internal estimates. As a result, says one former executive, there was pressure to, in effect, inflate the value of the contracts – even though it had no impact on the actual cash that was generated.***

Fortune, 12/24/01 (¶51).

> ***"If your boss was [fudging], and you have never worked anywhere else, you just assume that everybody fudges earnings," says one young Enron control person. "Once you get there and you realized how it was, do you stand up and lose your job? It was scary. It was easy to get into 'Well, everybody else is doing it, so maybe it isn't so bad.'"***

* * *

> ***The flaw only grew more pronounced as Enron struggled to meet the wildly optimistic expectations for growth it had set for itself. "You've got someone at the top saying the stock price is the most important thing, which is driven by earnings," says one insider. "Whoever could provide earnings quickly would be promoted."***
>
> ***The employee adds that anyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants. She says there was little scrutiny of whether the earnings were real or how they were booked. The more people pushed the envelope with aggressive accounting, she says, the harder***

they would have to push the next year. "It's like being a heroin junkie," she said. "How do you go cold turkey?"

Business Week, 2/25/02 (¶51). In fact, in mid-8/01, an Enron executive (who was a former Andersen accountant) wrote Lay, telling him the Company was "***nothing but an elaborate accounting hoax***," and, in referring to the SPE transactions, that nothing "***will protect Enron if these transactions are ever disclosed in the bright light of day***" – warning that many employees believed "***[W]e're such a crooked company***." ¶51.

By 97-98, Enron was a hall of mirrors inside a house of cards – reporting hundreds of millions of dollars of phony profits, while concealing billions of dollars of debt that should have been on its balance sheet – inflating its shareholder equity by billions of dollars. Enron had turned into the largest Ponzi scheme in history – constantly raising fresh money by selling its securities or those of related entities, while appearing to achieve successful growth and profits. But, because Enron's reported profits were being generated by phony, non-arm's-length transactions and improper accounting tricks – including the abuse of "mark-to-market" accounting[2] to accelerate the recognition of hundreds of millions of dollars of profits to ***current periods*** from transactions in which Enron was

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[2] Enron engaged in several accounting tricks and manipulations to falsify its financial results during the Class Period. Chief among these was the abuse of "***mark-to-market accounting***" whereby Enron computed the purported profit it would ultimately obtain on a multi-year contract, discount that to present value and recognize the entire "mark-to-market" profit in the current period. Unless Enron's expected profit on the transaction was truly hedged, Enron was required in each following quarter to recompute or readjust the profit computation to adjust for changing economic values. "Mark-to-market" accounting was appropriate only where Enron had a long-term track record which gave it the ability to accurately estimate and forecast future values (as was true with certain aspects of Enron's wholesale energy business). However, Enron misused and abused mark-to-market accounting ***throughout its entire business to grossly inflate its reported revenues and profits***. In Enron's wholesale energy business this was done by assigning unrealistic values to wholesale energy transactions which inflated current period income. In Enron's EES business where Enron had no long-term track record to justify the use of mark-to-market accounting, Enron nevertheless consistently utilized mark-to-market accounting to record huge current period profits on long-term, highly speculative retail energy risk-management contracts which, in fact, Enron had no basis to project a profit on and in fact knew would likely result in losses. Finally, in Enron's EBS business – also a new business where Enron had absolutely no track record which would justify the use of mark-to-market accounting – Enron utilized mark-to-market accounting to generate hundreds of millions of dollars of phony current period profits in several transactions. Enron not only abused mark-to-market accounting to initially value multi-year transactions to generate inflated current period profits, it also, when reviewing those computations on a quarterly basis as it was required to do, consistently ***increased*** the estimated value of the transaction even though subsequent data revealed ***a reduction of the estimated value of the transaction, a practice known within Enron as "moving the curve***." ¶36.

only entitled to receive ***cash over many future years*** – Enron was cash starved. Yet to continue to report ***growing*** profits, Enron was forced to not only continue to engage in such transactions and accounting abuses, ***but to accelerate the number and size of such transactions it engaged in***. This created a vicious cycle further exacerbating Enron's need to obtain cash from these transactions. To make matters worse, Enron had capitalized certain controlled entities it was doing phony deals with (and which Enron's bankers and their executives were helping to fund), with shares of Enron stock and ***had agreed to issue millions of additional shares of its stock to these entities if Enron's stock price declined below certain "trigger prices,"*** *i.e.*, $83, $81, $79, $68, $60, $57, $52, $48, $34 and $19 per share ***and to become liable for the debt of those entities if Enron lost its investment grade credit rating***. Because of the "triggers" and the way Enron capitalized these entities, it was absolutely vital to Enron and Andersen and the other participants in the fraudulent scheme and course of business that Enron's stock continue to trade at high levels and that Enron maintain its "investment grade" credit rating, otherwise the scheme would unravel. ¶¶18, 20.

Enron became completely dependent on maintaining its investment grade credit rating and a high stock price so that Enron could continue to have access to the capital markets to borrow billions in commercial paper and to enable it to periodically raise hundreds of millions of dollars of new longer term capital it needed to repay its commercial paper debt and the short-term loans it was receiving from its banks to sustain its business operations and so the stock issuance "triggers" would not be hit which would force Enron into a death spiral. ¶20.

C. The Partnerships and SPEs

To falsify Enron's reported financial condition and results, Enron and Andersen engaged in a series of purported "partnership" and "related party" transactions with the entities known as SPEs. GAAP requires majority-owned entities to be consolidated into the financial statements of the majority owner unless control rests with another. ¶431. Enron, Andersen, its partners and other defendants devised a scheme to account for entities Enron controlled, including Chewco, LJM, and LJM2, so the Company could avoid consolidating these entities and thereby conceal its massive debt and losses. These defendants abused an accounting provision that allows, under discreet circumstances, for the nonconsolidation of certain subsidiaries. Andersen knowingly misapplied

guidance from FASB Emerging Issues Task Force ("EITF") Abstract No. 90-15, which on its face pertains only to leasing transactions. According to EITF 90-15, a majority owner can avoid consolidating its subsidiaries if the initial equity investment of an unrelated third party totals at least 3% (or more depending on the circumstances). ¶433. For Enron and Andersen, this 3% minimum became a benchmark for determining whether to consolidate any SPE. Notwithstanding that EITF 90-15 does not even apply to the sort of SPEs Enron was forming, Andersen knew many of Enron's SPEs lacked an initial independent equity investment of at least 3%. Andersen, moreover, knew Enron effectively controlled the SPEs and, under GAAP, was therefore required to consolidate them. ¶¶431-433, 910.

In 99, Enron and Andersen created two LJM partnerships (LJM and LJM2) which Enron secretly controlled. Enron then engaged in numerous transactions – which were, in fact, manipulative contrivances – with the LJM partnerships and associated SPEs, which inflated Enron's reported profits by more than a billion dollars – at the same time enriching Enron's CFO (Fastow) and his friends and all of Enron's banks or bankers named as defendants, who had been secretly allowed to invest in the LJM2 partnership as a reward for their participation in the scheme – by hundreds of millions of dollars. The reason for establishing these partnerships was that they would permit Enron to accomplish transactions it could not otherwise accomplish with an independent entity, by providing Enron with a buyer of assets that Enron wanted to sell. ¶23. Thus, one of the primary vehicles used to falsify Enron's financial results during 99-01 was LJM2, which Enron used to create numerous SPEs (including the infamous "Raptors") which engaged in non-arm's-length fraudulent transactions to artificially inflate Enron's profits while concealing billions of dollars of its debt on terms so unfair to Enron that the deals provided huge returns to the LJM2 investors. ¶24.

Because the LJM2 partnership was going to be so lucrative to investors in that entity ***and provide exceptional returns as the Enron Ponzi scheme continued***, Enron and the banks decided that in funding LJM2, they would ***allow certain favored high-level officers of the banks to invest in LJM2***. The LJM2 partnership offering memorandum by which Enron brought investors into the partnership – ***which was not a public document*** – contained an invitation to benefit from the self-dealing transactions that LJM2 would engage in. It stressed the "***unusually attractive investment***

opportunity" resulting from LJM2's connection to Enron. It emphasized Fastow's position as Enron's CFO, and that LJM2's day-to-day activities would be managed by Fastow, and other Enron insiders.[3] It explained that "***[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities***" and that it "***expects to benefit from having the opportunity to invest [some $150 million] in Enron-generated investment opportunities that would not be available otherwise to outside investors***." It specifically noted that Fastow's "***access to Enron's information pertaining to potential investments will contribute to superior returns." In addition, investors were told that investors in a similar Fastow-controlled partnership (JEDI) that had done deals with Enron like the ones LJM2 would do had tripled their investment in just two years and that overall returns of 2,500% to LJM2 investors were actually anticipated***. ¶25. Enron and Andersen knew that because LJM2 was going to engage in transactions ***with Enron where Enron insiders would be on both sides of the transactions, the LJM2 partnership would be extremely lucrative – a deal that was virtually guaranteed to provide huge returns to LJM2's investors as the Enron Ponzi scheme went forward***. ¶24. In short, the non-public offering memorandum was an invitation to join in the benefits of non-arm's-length self-dealing transactions with Enron, *i.e.*, the looting of Enron. ***Enron's bankers and the top executives of those banks were permitted to invest in LJM2 as a reward to them for their ongoing participation in the scheme – a sure thing for them***. ¶¶24-25.[4]

It was indispensable to the scheme that LJM2 be funded at year-end 99 to serve as a vehicle to consummate several transactions with Enron before year-end 99 to create huge profits for Enron in the 4thQ 99 so that Enron could meet and exceed its forecasted 99 earnings. However, as had

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[3] In fact, Fastow's dual role by which he could self-deal on behalf of the LJM2 partnership with Enron's assets was so important ***that investors in LJM2 were assured that they did not have to make any additional capital contributions if Fastow's dual role ended***. ¶24.

[4] While Enron's publicly filed reports disclosed the existence of the LJM partnerships, these disclosures did not reveal the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not fully disclose the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and to disguise their substance and import. The disclosures also represented that the related-party transactions were reasonable compared to transactions with third parties when, in fact, they were not. ¶67.

been the case with Chewco at year-end 97, there was tremendous time pressure and Enron (which was raising the private equity capital for LJM2) could not complete the formation of LJM2 and raise sufficient money from the equity investors in LJM2 in time to fully form or fund LJM2 by year-end 99 with sufficient capital to enable it to do the desperately needed transactions with Enron. So, in 12/99, in an extraordinary step, Andersen and other defendants, knowing that LJM2 was going to be an extremely lucrative investment anyway, created documentation that enabled the banks to advance virtually 100% of the monies needed to initially fund LJM2. ¶26. The reason the banks and their top executives put up the money to pre-fund LJM2 was that they knew that enabling Enron to do the 99 year-end deals with the LJM2 and its SPEs was indispensable to Enron avoiding reporting a very bad 4thQ 99 – which would have caused its stock to plunge. ¶28.

From 6/99 through 6/01, Enron entered into numerous non-arm's-length fraudulent transactions with the LJM partnerships. Enron sold assets to LJM that it wanted to get off its books on terms that no independent third party would ever have agreed to. ***The transactions between the LJM partnerships and Enron or its affiliates occurred close to the end of financial reporting periods to artificially boost reported results to meet forecasts Enron and other participants in the scheme had been making***. For instance, near the end of the 3rd and 4thQ 99, Enron sold interests in seven assets to LJM and LJM2 in transactions that Andersen structured, reviewed, and allowed. The transactions permitted Enron to conceal its true debt levels by removing the assets from Enron's balance sheet and, at the same time, record large gains. However, (i) as it had agreed in advance it would do, Enron bought back five of the seven assets after the close of the financial reporting period; (ii) the LJM partnerships made large profits on every transaction, even when the asset they had purchased actually declined in market value; and (iii) those transactions generated "earnings" for Enron of $229 million in the second half of 99 out of total earnings for that period of $549 million. In three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against any loss. Thus, the LJM partnerships functioned only as vehicles to accommodate defendants in the manipulation, falsification and artificial inflation

of Enron's reported financial results, while enriching the LJM investors who were benefitting from the looting of Enron. ¶32.[5]

Andersen and its partners knew Enron's transactions with the LJM partnerships served no economic purpose other than concealing debt and losses and enriching Fastow and other Enron executives. ¶¶948, 950. CFO Fastow and other Enron executives controlled LJM and LJM2 and reaped tens of millions of dollars in management fees and purported appreciation of their investments in the partnerships. ¶¶948, 949(a) and (d), 950. LJM2's private offering memorandum – which Andersen partners read – revealed that Enron retained significant economic and operating interests in the investments and trumpeted the superior returns to be expected as a result of its general partners obtaining inside information from Enron. ¶¶948, 950. The private offering memorandum also disclosed that Enron was carrying at least $17 billion in assets, 33% of the Company's total, off its balance sheet. ¶¶948, 949(b). Moreover, no later than 12/99, PSG partner Carl Bass, a member of an Andersen national team of auditing experts and overseers, was objecting vociferously to Enron's treatment of the LJM SPEs. ¶913. One month before Andersen certified Enron's 99 financial statements, Bass, in an e-mail to defendants Stewart and Neuhausen, characterized several SPE transactions as "look[ing] like there is no substance" to them. ¶929. Yet Andersen continued to issue clean audit reports on Enron's financial statements.

One "hedging" transaction with LJM in 6/99 involved Rhythms NetConnections ("Rhythms") stock owned by Enron, to "hedge" Enron's huge gains in Rhythms stock and enable Enron to create a huge profit. Enron transferred its own stock to the SPE in exchange for a note. But if the SPE were required to pay Enron on the "hedge," the Enron stock would be the source of payment. Enron's purported hedge of its Rhythms position was never a true economic hedge, because LJM's ability to meet its obligations depended on the strong performance of Enron stock. ¶¶33, 456. GAAP precluded Enron from recognizing income due to increases in the value of its capital stock,

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[5] The returns to the LJM2 investors were huge – up to 2,500% on one deal and 51% overall ***in the first year*** of the partnership. ***Skilling has recently told investigators such gargantuan returns were possible only because LJM2, with Fastow at the wheel, was defrauding Enron in the billions of dollars of deals it was doing with Enron so Enron could create false profits and hide billions of dollars in debt***. Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicion of Fraud," *New York Times*, 4/24/02.

yet Andersen approved these transactions. Other "hedging" transactions occurred in 00 and 01 and involved SPEs known as the "Raptor" vehicles. These were also structures, funded principally with Enron's own stock, that were intended to "hedge" against declines in the value of certain of Enron's merchant investments. These transactions were not economic hedges. They actually were manipulative devices devised to circumvent accounting rules. The economic reality was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron. Enron and Andersen used these contrivances and manipulative devices to inflate Enron's reported financial results. In 99, Enron recognized income of over $100 million from the Rhythms' "hedging" transaction. ***In the last two quarters of 00, Enron recognized pre-tax earnings of $530 million on several transactions with the Raptor entities*** out of reported pre-tax earnings of $650 million. These ***"earnings" from the Raptors' manipulative contrivances accounted for more than 80% of the total***! ¶33.

Hedging Enron's investments with the value of Enron's stock created an enormous and unusual motive for the participants in the scheme to keep Enron stock trading at inflated levels. This was because if the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This happened in late 00 and early 01. In 12/00, Enron's gain (and the Raptors' corresponding net loss) on these transactions was over $500 million. Enron could recognize these gains – offsetting corresponding losses on the investments in its merchant portfolio – ***only if the Raptors had the capacity to make good on their debt to Enron***. If they did not, Enron would be required to record a "credit reserve," a loss that would defeat the very purpose of the Raptors, which was to shield Enron from reflecting the decline in value of its merchant investments. ¶34.

As year-end 00 approached, two of Enron's LJM2-financed Raptor SPEs were in danger of coming unwound as they lacked sufficient credit capacity to support their obligations. If something were not done to prevent the unwinding of these SPEs, Enron would have to take a multi-million dollar charge against earnings which would expose the prior falsification of Enron's financial results and result in Enron's stock plunging, more and more of the stock issuance "triggers" in the LJM2 SPEs would be hit, and a vicious fatal down-cycle would kick in. Therefore, with the participation of Andersen, Enron restructured and capitalized the LJM2-financed Raptor SPEs at year-end 00 by

transferring to them rights ***to receive even more shares*** of Enron stock, creating ever-increasing pressure on Enron and the other participants in the scheme to support Enron's stock price. This artifice enabled Enron to avoid recording a huge credit reserve for the year ending 12/31/00. ¶35.

Andersen and its partners knew the Raptor transactions were manipulative devices when they certified Enron's financial statements as complying with GAAP. Even a cursory review of the Raptor transactions revealed they violated several fundamental accounting precepts. ¶¶951-952. Basic accounting principles forbid companies from recognizing the appreciation of their own stock as income. The substance of the Raptors transactions effectively allowed Enron to report net income and gains on its income statement that were backed almost entirely by Enron stock, and contracts to receive Enron stock, which the Raptors held. In essence, these transactions conjured income from thin air. ¶952(a). Andersen also allowed Enron to avoid recording individual impairment charges for Raptor investments that suffered substantial, permanent declines in value. ¶952(c). Defendants Cash, Duncan, Lowther, Odom and Stewart blessed Enron's accounting for the Raptors, though PSG partner Bass warned them that Enron's accounting for the SPEs was deceptive. ¶¶929, 952(c). Ultimately, Enron reduced its shareholders' equity by $1 billion to reverse the improper accounting for the Raptor transactions. ¶494.

D. Enron Energy Services ("EES")

The falsification of Enron's financial results was not limited to non-arm's-length fraudulent illicit partnership and SPE transactions. While Enron's wholesale energy business was the largest single contributor to its profits, Enron and its banks were also telling investors that an area of tremendous growth for Enron was its retail energy services business – EES – whereby Enron purportedly undertook to manage the energy needs of corporate consumers for multi-year periods in return for fees to be paid over a number of years. Enron and its banks presented this business as achieving tremendous success by constantly signing new multi-million or even billion-dollar contracts which allowed EES to exceed internal forecasts and that this division had turned profitable in the 4thQ 99 and was achieving substantial gains in its profitability thereafter. ¶37.

However, EES was actually losing hundreds of millions of dollars. This was because in order to induce large enterprises to sign long-term energy management contracts and "jumpstart" this

business so it could appear to obtain huge contract volumes, Enron was entering into EES management contracts which it knew would likely result in huge losses. However, by the abuse of mark-to-market accounting, Enron grossly overvalued the ultimate value of these contracts and created greatly inflated current period profits from transactions which generated little, if any, current period cash, and which would likely actually result in long-term cash out plans and losses. As a letter written in 8/01 to Enron's Board by an EES manager stated just after Skilling "resigned"(¶38):

> One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrongdoings of the various management teams at Enron ... (*i.e.*, ***EES's management's ... hiding losses/SEC violations***).
>
> * * *
>
> ... [I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked.
>
> * * *
>
> ... [I]t will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion.... [T]hey decided ... to hide the $500MM in losses that EES was experiencing.... ***EES has knowingly misrepresented EES['s] earnings. This is common knowledge among all the EES employees, and is actually joked about. But it should be taken seriously***.

E. Enron Broadband ("EBS")

Another purported growth area of Enron's business was its broadband services business – EBS – which consisted of constructing an 18,000-mile fiber optic network which Enron was constructing and engaging in trading access to Enron's and others' fiber optic cable capability, *i.e.*, "Broadband Intermediation." Enron and its banks presented ***both parts*** of Enron's broadband business as poised to achieve and later as actually achieving huge success, reporting that its fiber optic network was being or had been successfully constructed, was state of the art and provided unparalleled quality of service, and that its broadband trading business was succeeding and achieving much higher trading volume and revenues than expected – *i.e.*, "***exponential growth***." ¶39.

A prime example of the purported success of Enron's broadband content business was its video-on-demand ("VOD") joint venture with Blockbuster Entertainment, announced in 7/00. Enron presented this 20-year agreement as having a ***billion dollar value***, that it was a ***first-of-its-kind product*** whereby consumers would obtain VOD content from Blockbuster in their home as if they

were watching the movie on their own VCR (start, stop, rewind) and that this incredible advance in technology was made possible due to the ***high quality of Enron's fiber optic network***. Abusing mark-to-market accounting and an LJM2 SPE, Enron recognized an astonishing $110+ million profit on this deal in the 4thQ 99 and 1stQ 00, even though the project was failing in its test markets because Enron did not have the technology to deliver the product as represented – and which could never have gone forward because Blockbuster did not have the legal right to deliver movies in a digital format, the only format which could be utilized for VOD. ¶40.[6]

F. New Power

Another example of how Enron and Andersen misrepresented Enron's reported results is the New Power IPO in 10/00, by which Enron improperly recognized a $370 million profit in the 4thQ 00. Enron controlled New Power and owned millions of shares of New Power stock. If Enron and its banks could take New Power public and create a trading market in its stock, then Enron could recognize a profit on the gain in value on its shares by "hedging" that gain via yet another non-arm's-length transaction via LJM2. In the 4thQ 00, Enron desperately needed to create profits to perpetuate the Ponzi scheme. Enron and its bankers did the New Power IPO – 27.6 million shares at $21 per share in 10/00. Then, in a deal secretly structured before the IPO, Enron created a phony profit using an LJM2 SPE called Hawaii 125-0. CIBC and other of Enron's banks made a "loan" of $125 million to Hawaii 125-0, ***but secretly received a "total return swap" guarantee to protect them against any loss from Enron***. Enron transferred millions of New Power warrants to Hawaii 125-0 to "secure" the banks' loan and thus created a huge $370 million "profit" on the purported gain on the New Power warrants. Hawaii 125-0 simultaneously supposedly "hedged" the warrants with another entity created and controlled by Enron called "Porcupine." To supposedly capitalize Porcupine, LJM2 put $30 million into Porcupine to facilitate the so-called hedge of the New Power warrants, but, one

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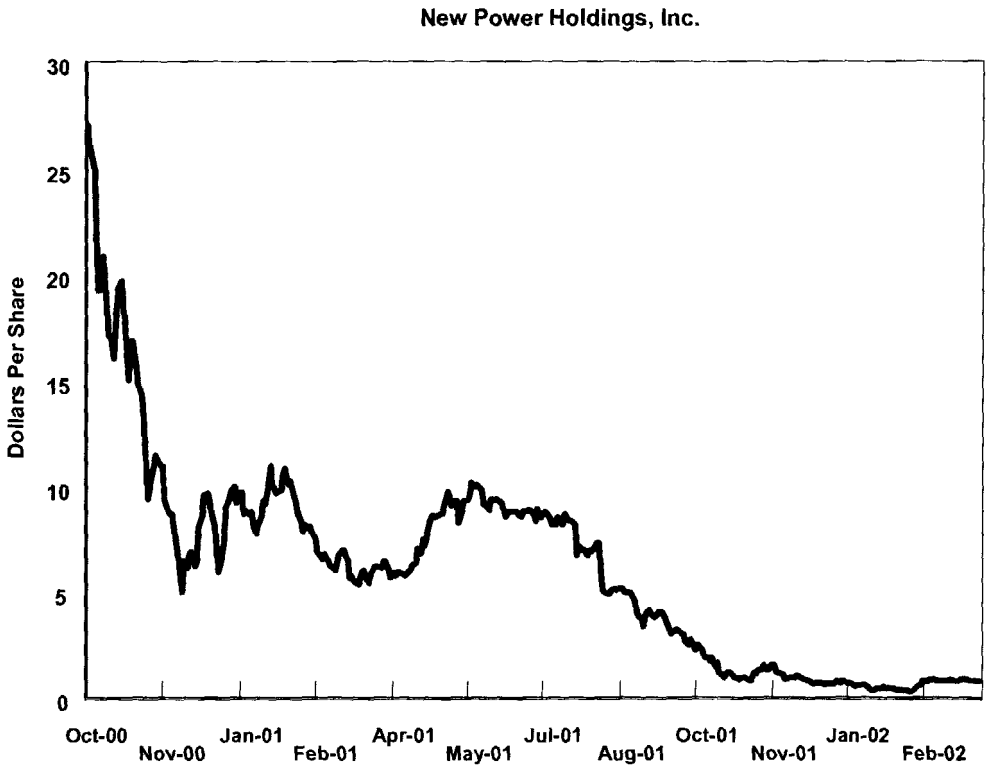
[6] Just eight months after announcing this contract with great fanfare and just weeks after representing that testing of the system in four cities had ***succeeded*** and that the service was being launched nationwide, Enron was forced to abandon the venture. But Enron did not reverse the huge profits it had secretly recorded on this transaction, for to do so would have not only exposed its ongoing abuse and misuse of mark-to-market accounting, but also would have crushed Enron's stock at a time when Enron and the other participants in the scheme were desperately attempting to halt Enron's then falling stock price so that it would not fall below certain trigger prices. ¶41.

week later, Porcupine paid the $30 million back to LJM2 plus a $9.5 million profit – leaving Porcupine with no assets. New Power stock immediately fell sharply, as the chart below shows:



This collapse converted Enron's huge gain on its New Power equity holdings into a huge loss early in 01 – a loss of about $250 million – which was concealed. ¶42.

G. Hidden/Disguised Loans

Another tactic utilized by Enron to falsify Enron's financial condition and hide debt involved manipulative transactions with JP Morgan, CitiGroup and CS First Boston. JP Morgan used an entity it controlled known as "Mahonia," located in the Channel Islands off England. JP Morgan and Enron utilized a scheme which JP Morgan had utilized before with a commodities trader from Sumitomo, by which large bank loans are disguised as commodity trades. In fact, offsetting trades were arranged with the ultimate cost differential being in favor of the bank, representing the interest

rate on the disguised loan. By utilizing this manipulative device, JP Morgan and Enron falsified Enron's financial condition, concealing some $4 billion in debt. ¶44.[7]

CitiGroup and CS First Boston engaged in similar subterfuges to disguise large loans to Enron. CitiGroup lent Enron $2.4 billion via "pre-paid" swaps – the so-called "Delta" transactions – conducted through CitiGroup's Cayman Island subsidiary. These swap transactions perfectly replicated loans and were, in fact, loans – but Enron never reported them as such on its balance sheet. CS First Boston also engaged in making disguised loans to Enron. CS First Boston gave Enron $150 million to be repaid over two years, with Enron's payments to vary with the price of oil. The transaction was made to appear to be a "swap," but was, in fact, a loan – a reality admitted by the bank: "***It was like a floating-rate loan***," said Pen Pendleton, a CS First Boston spokesman. "***We booked the transaction as a loan***." However, Enron did not show the loans on its balance sheet. ¶45.

By so doing, JP Morgan, CitiGroup and CS First Boston were able to ***secretly*** prop up Enron's deteriorating finances without disclosing that in fact, Enron ***had borrowed between $4-$6 billion from those banks***. Also astonishing about the Mahonia and Delta transactions is the way JP Morgan and CitiGroup were "***paid off***" to engage in this manipulative subterfuge. Based on Enron's purported investment grade credit rating, Enron could have borrowed money from banks at 3.75%-4.25%. However, in the phony Mahonia and Delta transactions, ***Enron paid JP Morgan and CitiGroup between 6.5%-7.0% for the disguised loans – a huge difference from the cost of a legitimate bank loan – which made these disguised loans hugely profitable for JP Morgan and CitiGroup*** – in effect paying them off for participating in these bogus transactions. ¶46.

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[7] Knowing Enron's true financial condition was precarious, JP Morgan attempted to insure against default on those disguised loans by buying performance bonds from several insurance companies. However, the insurers have refused to pay, alleging that in fact, the commodity trades were fraudulent and a subterfuge to conceal the real nature of the transactions, *i.e.*, done for the purpose of disguising loans. ***A federal district court judge has ruled that there is significant evidence to support the insurers' claims of fraud and deception and that these transactions were, in fact, disguised loans***. ¶44.

H. Enron's Access to the Capital Markets

Enron required constant access to huge amounts of capital. For Enron to continue to appear to succeed it had to keep its investment grade credit rating and keep its stock price high. Enron's investment grade credit rating and high stock price could ***only*** be maintained by (i) limiting the amount of debt shown on Enron's balance sheet; (ii) reporting strong current period earnings; ***and*** (iii) forecasting strong future revenue and earnings growth. Yet Enron was able to achieve these ends only by pursuing an increasing number of phony transactions, many of which were accomplished by increasing the number and size of transaction entities which were supposedly independent of Enron but which, in fact, Enron controlled through a series of secret understandings and illicit financing arrangements, including the LJM2 partnerships. As a result of reporting strong earnings, the apparent success of its business and its future earnings growth forecasts, Enron had unlimited access to the capital markets, borrowing billions of dollars in the commercial paper markets and by selling billions of dollars of Enron securities to the public. Enron and its bankers, working with Andersen, raised over $6 billion in new debt and equity capital from public investors through numerous securities offerings, thus raising the capital necessary to allow Enron to repay or pay down its short-term debt and continue to operate. These Enron offerings are shown below (¶48):

ENRON SECURITIES UNDERWRITINGS	
Date of Offering	**Security Sold**
11/96	8 million shares Enron Capital Trust I 8.3% Trust Originated Preferred Securities at $25 per share
7/97	$100,000,000 6-5/8% Enron Notes
8/97	$150,000,000 6.5% Notes due 8/1/2002
11/97	$200,000,000 Remarketed Reset Notes due 11/15/2037
1/97	6 million shares Enron Capital Trust II 8-1/8% Trust Originated Preferred Securities at $25 per share
11/97	$250,000,000 6.625% Notes due 11/15/2005
11/97	$300,000,000 6.45% Notes due 2001

Date of Offering	Security Sold
5/98	35 million shares of common stock at $25 per share
7/98	$250,000,000 6.40% Notes due 7/15/2006 $250,000,000 6.95% Notes due 7/15/2028
9/98	$250,000,000 Floating-rate Notes due 3/30/2000
11/98	$250,000,000 6.95% Notes due 7/15/2028
2/99	27.6 million shares of common stock at $31.34
5/19/99	$500,000,000 7.375% Notes due 5/15/2019
8/10/99	$222,500,000 7% Exchangeable Notes due 7/31/2002
5/00	$500,000,000 Notes due 5/23/2005 and 6/15/2003
2/01 (private placement) 7/01 (resales)	$1,907,698,000 Zero Coupon Convertible Senior Notes due 2021, original issue date 2/7/2001

None of these offerings would have been possible without Andersen's consent to include its false and misleading audit opinion in the registration statements.

I. Late 00/Early 01 Prop-Up

In late 00/early 01, Enron's financial results began to come under scrutiny from a few accounting sleuths and short-sellers, who began to question the quality of Enron's reported financial results. While Enron, its top insiders and its bankers assured investors of the correctness of Enron's accounting and the high quality of Enron's reported earnings, the success and strength of its business and its solid prospects for continued strong profit growth, in part because of this increasing controversy, Enron's stock began to decline. As this price decline accelerated, it put pressure on Enron's top executives to do something – anything – to halt the decline in the price of the stock as they knew that if that price decline continued and the stock fell to lower levels, more and more of the Enron stock "triggers" contained in agreements for LJM2 SPE deals would be triggered, ***which***

would require Enron to issue over 100 million shares of its common stock to those partnerships, causing a huge reduction in Enron's shareholders' equity. ¶52.

In late 3/01, inside Enron it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect a shortfall in credit capacity of the LJM2-financed Raptor SPEs, which would have been catastrophic and exposed the scheme. Rather than take that loss and face these consequences, Enron "restructured" the LJM2-financed Raptor vehicles by transferring ***more than $800 million of contracts to receive Enron's own stock to them just before quarter-end, which permitted the participants in the scheme to conceal substantial losses in Enron's merchant investments, keep billions of dollars of debt off Enron's balance sheet and allowed the Enron Ponzi scheme to continue.*** ¶53.

During early 01, Enron continued to report record results and it and its bankers continued to make very positive statements (¶54):

- Enron's strong results reflected breakout performance in all business units. Enron was a strong unified business.
- WEOS had strong growth and a tremendous market franchise with significant sustainable competitive advantages.
- EBS intermediation was great. Broadband glut and lowered prices ***would help Enron***.
- VOD was successfully tested and launched. Proven technology created enormous opportunities.
- All of Enron's businesses were generating high levels of earnings. Fundamentals were improving. Enron was very optimistic. Enron was confident growth was sustainable for years to come.

J. The Impending Collapse

By the Summer of 01, Enron realized that it would not be able to continue to sustain the illusion of strong profitable growth and that it would have to take large write-offs in the second half of 01 that, in turn, could result in a downgrade of Enron's critical investment grade credit rating – an event that defendants knew would mean that debt on the books of the SPEs Enron did business with (and partnerships controlled by them), which debt Enron had assured investors was "***non-recourse***" to Enron would, in fact, become Enron's obligation. ¶55.

On 8/14/01, Enron announced that Skilling – who had become Enron's CEO just months earlier – was resigning, for "***personal reasons***." While this resignation fanned the controversy over the true nature of Enron's finances and the condition of Enron's business, Enron and its banks lied to investors, telling them that Skilling's resignation was only for personal reasons and did not raise "***any accounting or business issues of any kind***" and that Enron's financial condition "***had never been stronger***" and its "***future had never been brighter***." They said there was "***nothing to disclose***," Enron's "***numbers look good***," there were "***no problems***" or "***accounting issues***." According to them, the Enron "***machine was in top shape and continues to roll on – Enron's the best of the best***." ¶57.

K. The End

By 8/01, inside Enron management employees were complaining to Enron's Board that the fraud at Enron was so widespread it was out of control. In 8/01, two employees complained to the Board (¶59):

A. One employee wrote:

> Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.
>
> * * *
>
> We have recognized over $550 million of fair value gains on stock via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm. The New Power Co. by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.
>
> ***I am incredibly nervous that we will implode in a wave of accounting scandals.... [T]he business world will consider the past successes as nothing but an elaborate accounting hoax....***
>
> ***[W]e booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse.*** We are under too much scrutiny and there are probably one or two disgruntled "redeployed" employees who know enough about the "funny" accounting to get us in trouble.

* * *

I realize that we have had a lot of smart people looking at this .... ***None of that will protect Enron if these transactions are ever disclosed in the bright light of day*****.....**

* * *

I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.

* * *

3. ***There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly****....*

   a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. ***He complained mightily to Jeff Skilling*** .... 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets ....

   b. ***Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.***

   c. I have heard one manager level employee ... say "***I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company."... Many similar comments are made when you ask about these deals****....*

   B. A second employee wrote:

One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrong doings of the various management teams at Enron. However ... I'm sure the board has only scratched the surface of the impending problems that plague Enron at the moment. (*i.e.*, EES's ... hiding losses/SEC violations ... lack of product, etc.).

* * *

[I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked. (JC Penney being a $60MM loss alone, then Safeway, Albertson's, GAP, etc.). Some customers threatened to sue if EES didn't close the deal with a loss (Simon Properties – $8MM loss day one).... Overnight the product offerings evaporated.... Starwood is also mad since EES has not invested the $45MM in equipment under the agreement.... Now you will loose [sic] at least $45MM on the deal.... You should also check on the Safeway contract, Albertson's, IBM and the California contracts that are being negotiated.... It will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion....

This is when they decided to merge the EES risk group with Wholesale to hide the $500MM in losses that EES was experiencing. But somehow EES, to everyone's amazement, reported earnings for the 2nd quarter. According to FAS 131 – Statement of Financial Accounting Standards (SFAS) #131, "Disclosures about Segments of an Enterprise and related information," EES has knowingly misrepresented EES' earnings. This is common knowledge among all the EES employees, and is actually joked about....

There are numerous operational problems with all the accounts.

* * *

... Some would say the house of cards are falling....

You are potentially facing Shareholder lawsuits, Employee lawsuits ... Heat from the Analysts and newspapers. The market has lost all confidence, and its obvious why.

You, the board have a big task at hand. You have to decide the moral, or ethical things to do, to right the wrongs of your various management teams.

* * *

... But all of the problems I have mentioned, they are very much common knowledge to hundreds of EES employees, past and present.

On 10/16/01, Enron shocked the markets with revelations of $1.0 billion in charges and a reduction of shareholders' equity by $1.2 billion. Within days, *The Wall Street Journal* began an exposé of the LJM SPEs, the SEC announced an investigation of Enron, and Fastow, "resigned." In 11/01, Enron was ***forced to admit that Chewco had never satisfied the SPE accounting rules and – because JEDI's non-consolidation depended on Chewco's status – neither did JEDI, and Enron consolidated Chewco and JEDI retroactive to 97. This retroactive consolidation resulted in a massive reduction in Enron's reported net income and massive increase in its reported debt.*** Enron then revealed that it was restating its 97, 98, 99 and 00 financial results to eliminate $600 million in previously reported profits and approximately $1.2 billion in shareholders' equity as detailed below (¶61):

ENRON ACCOUNTING RESTATEMENTS				
	1997	1998	1999	2000
Recurring Net Income Amount of Overstatement	$ 96,000,000	$113,000,000	$ 250,000,000	$ 132,000,000
Debt Amount of Understatement	$711,000,000	$561,000,000	$ 685,000,000	$ 628,000,000
Shareholders' Equity Amount of Overstatement	$313,000,000	$448,000,000	$ 833,000,000	$1,208,000,000

These partnerships – Chewco, LJM and LJM2 – ***were used by Enron and its banks to enter into transactions that Enron could not, or would not, do with unrelated commercial entities***. The

significant transactions were designed ***to create phony profits or to improperly offset losses***. These transactions allowed Enron to conceal from the market ***very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged – that is, that a third party was obligated to pay Enron the amount of those losses, when in fact that third party was simply an entity in which only Enron had a substantial economic stake. The Raptors transactions with LJM2 alone resulted in Enron reporting earnings from the 3rdQ 00 through the 3rdQ 01 that were almost $1 billion higher than should have been reported***! ¶62.[8]

Notwithstanding the write-offs and restatement revelations of 10/01-11/01, Enron, JP Morgan and CitiGroup believed that they could limit their legal exposure for participation in the scheme if they could sell Enron to another company. So, in 11/01, as the Enron scheme began to unravel, Enron tried desperately to arrange a salvation merger with Dynegy to avoid the insolvency of Enron and the inevitable investigations and revelations that would follow such insolvency. ¶64. However, the due diligence efforts of Dynegy uncovered that the true financial condition of Enron was far worse than had been disclosed publicly and that Enron had been engaged in a wide-ranging falsification of its financial statements over the several prior years. Thus, Dynegy refused to acquire Enron. By 11/28/01, Enron's publicly traded debt had been downgraded to "junk" status. On 12/2/01, Enron filed for bankruptcy – ***the largest bankruptcy in history***. Enron stock and publicly traded debt securities have become virtually worthless, inflicting billions of dollars of damage on purchasers of those securities. ¶66.

As *Newsweek* has written:

> In the late 1990s, by my count, Enron lost about $2 billion on telecom capacity, $2 billion in water investments, $2 billion in a Brazilian utility and $1 billion on a controversial electricity plant in India. Enron's debt was soaring. If these harsh truths became obvious to outsiders, Enron's stock price would get clobbered – and

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[8] As huge as the 11/01 restatements of Enron's 97-00 financial statements were, they just scratched the surface of the true extent of the prior falsification of Enron's financial statements, failing to eliminate additional hundreds of millions of dollars of phony profits as Enron, Andersen and the banks were still trying to keep Enron afloat and trying to conceal how extensive the fraud had really been. ¶63.

> a rising stock price was the company's be-all and end-all. Worse, what few people knew was that Enron had engaged in billions of dollars of off-balance-sheet deals that would come back to haunt the company if its stock price fell.

Newsweek, 1/21/02 (¶69).

> ***The key to the Enron mess is that the company was allowed to give misleading financial information to the world for years.*** Those fictional figures, showing nicely rising profits, enable Enron to become the nation's seventh largest company, with $100 billion of annual revenues. Once accurate numbers started coming out in October, thanks to pressure from stockholders, lenders and the previously quiescent SEC, Enron was bankrupt in six weeks. The bottom line: we have to change the rules to make companies deathly afraid of producing dishonest numbers, and we have to make accountants mortally afraid of certifying them. Anything else is window dressing.

Newsweek, 1/28/02 (¶69).

III. STANDARD OF REVIEW FOR MOTIONS TO DISMISS

The Court must accept the facts alleged in the CC as true and construe the allegations in the light most favorable to the plaintiffs. *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 406 (5th Cir. 2001). It may not adopt "its own interpretation" of events pled in the CC, nor may it give credence to "alternative" explanations, even ones the court believes are "more plausible." *Oran v. Stafford*, 226 F.3d 275, 286 n.5 (3d Cir. 2000). Dismissal is improper "unless it appears beyond doubt that the plaintiff can prove no set of facts in support his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

IV. PLAINTIFFS HAVE ADEQUATELY ALLEGED THE ANDERSEN PARTNERS' VIOLATIONS OF §10(b) AND RULE 10b-5

A. Plaintiffs Have Pled the Andersen Partners' Fraud with Particularity

The PSLRA requires defrauded investors to "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." 15 U.S.C. §78u-4(b)(1). In *Zonagen*, 267 F.3d at 412, the Fifth Circuit declared that these requirements are the same as those the Circuit has traditionally applied in assessing securities fraud claims under Rule 9(b), which oblige plaintiffs "'to specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent.'" *Accord In re Sec. Litig. BMC Software, Inc.* , 183 F. Supp. 2d 860, 901 (S.D. Tex. 2001). The PSLRA also requires plaintiffs who plead on information and belief to "state with particularity all

facts on which that belief is formed." 15 U.S.C. §78u-4(b)(1). But the Fifth Circuit does not compel plaintiffs to "'allege "all" facts that may be "related" to their claims,' since 'such a requirement is impossible at the pleading stage, because, in nearly every securities fraud case, only the defendants know "all" the facts related to the alleged fraud.'" *ABC Arbitrage v. Tchuruk*, No. 01-40645, 2002 U.S. App. LEXIS 9112, at *44 (5th Cir. May 13, 2002) (quoting *In re NetSolve, Inc.*, 185 F. Supp. 2d 684, 696 n.10 (W.D. Tex. 2001)). Even with the heightened pleading standards of the PSLRA, the Fifth Circuit does "'not require the pleading of detailed evidentiary matter in securities litigation.'" *Id.* at *49-*50.

The CC complies with the PSLRA and Rule 9(b) by identifying the Andersen Partners' statements and the circumstances under which they were made, by providing specific, contemporaneous facts to explain why they were false and misleading, and by providing a description of the documentary evidence on which its allegations are based. *Id.* at *30-*32, *46. Plaintiffs specify what was said, who said it, and where and when it appeared. *See, e.g.*, ¶¶126, 134, 140-141, 144, 156, 164-165, 177, 196, 215, 219, 221, 223, 246, 262, 281, 292, 295-297, 316, 328, 336, 364, 899. And plaintiffs plead ample facts showing why the Andersen Partners' statements were false when made. *See, e.g.*, ¶¶93, 913, 928-933, 938-940, 942, 946, 948-950, 952-953, 962-966. "The complaint sufficiently alleges which portions of the financial statements were overstated ... and which portions understated ... such that [the Andersen Partners] can prepare a reasonable defense to the allegations." *In re First Merchants Acceptance Corp. Sec. Litig.*, Civ. No. 97-C-2715, 1998 U.S. Dist. LEXIS 17760, at *26-*27 (N.D. Ill. Nov. 2, 1998); *see Kinney v. Metro Global Media, Inc.*, 170 F. Supp. 2d 173, 179 (D.R.I. 2001); *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 815, 821 (N.D. Ill. 2000); *In re Leslie Fay Cos. Sec. Litig.*, 835 F. Supp. 167, 174 (S.D.N.Y. 1993) (identification of specific audit violations is sufficient under Rule 9(b)).

Throughout their CC, plaintiffs detail the actions of specific Andersen partners. Plaintiffs state that on 12/18/99, PSG partner Bass wrote an e-mail to defendants Neuhausen and Stewart objecting to Enron's accounting for an SPE. ¶928. Two other e-mails from Bass to Stewart, sent 2/1 and 2/4/00 respectively, characterize Enron SPE transactions as "look[ing] like there is no substance." ¶929. In his 2/4 e-mail, Bass also disapproved of Enron's attempts to record revenue

from the appreciation in value of capital stock it contributed to an SPE. *Id.* In addition, plaintiffs identify other Andersen partners – Bauer and Cash – who knew of Bass' opposition to Enron's fraudulent accounting. *Id.* The Fifth Circuit recently found less detailed allegations sufficient to meet PSLRA's pleading requirements. *See ABC Arbitrage*, 2002 U.S. App. LEXIS 9112, at *49, *56.

Plaintiffs specify the fraudulent conduct of other Andersen partners. On 2/5/01, senior Andersen partners from the firm's Chicago headquarters, the Houston office, and the Gulf Coast Region convened to decide whether to retain Enron – the firm's second largest source of revenue – as a client. ¶¶906, 930. The CC identifies the meeting's attendees, including defendants Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart and Swanson. And plaintiffs describe the substance of the meeting. These defendants discussed the LJM related-party transactions and their distortion of Enron's income statement and balance sheet, the conflict of interest posed by Fastow's dual position as Enron CFO and LJM fund manager, Enron's aggressive structuring of SPE transactions, and Enron's mark-to-market accounting, which the partners characterized as mere "intelligent gambling." ¶930. Plaintiffs further explain why the Andersen Partners retained Enron as a client despite these significant red flags and known accounting irregularities: it was not "unforeseeable that fees [from Enron] could reach a $100 million per year amount considering the multi-disciplinary services being provided." ¶912.

B. The Andersen Partners' Material Misrepresentations

1. The Andersen Partners' False Statements About Enron's 97 and 98 Financial Statements

In 3/98, Enron issued its 97 10-K, which reported net income of $105 million, shareholders' equity of $5.62 billion, total debt of $6.25 billion, and earnings per share (EPS) of $0.16. ¶424. On 1/12/99, Enron filed a Registration Statement with the SEC to sell $1 billion of securities. ¶126. Andersen and the Andersen Partners consented to the incorporation of Enron's 97 audited financial in the Registration Statement. ¶¶126, 899. In 3/99, Enron issued its 98 Annual Report to Shareholders, which the Andersen Partners co-authored. ¶136. The Annual Report included Enron's 97 and 98 financial statements, certified by Andersen and the Andersen Partners, which reported for

98 net income of $703 million, shareholders' equity of $7.05 billion, total debt of $7.36 billion, and EPS of $1.01. ¶¶140, 424. Enron's certified financial statements for 97 and 98 were published in its 98 Form 10-K, also filed in March – and incorporated into Enron Registration Statements and Prospectuses. ¶¶141, 425, 617, 899. Andersen and the Andersen Partners represented that Enron's 97-98 financial statements complied with GAAP and certified that their audits of the statements comported with GAAS. ¶¶141, 899, 903-904.

Enron's financial statements for 97 and 98 have now been restated, and Andersen and the Andersen Partners have admitted that their audit opinions for these years "should not be relied upon." ¶955. GAAP only allows a restatement of prior financial statements ***based upon information "that existed at the time the financial statements were prepared,"*** indicating material errors in those prior financial statements. APB Opinion No. 20, at ¶13; *see In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010, 1026 (N.D. Ohio 2000)("Telxon, itself, admitted its prior disclosures were materially misstated when it issued the restatements which gave rise to this litigation."). Here, Enron's certified financials were false and misleading when issued because Enron failed to consolidate JEDI and Chewco into its annual financial reports. ¶155(d). By omitting these entities from its financial statements, Enron understated its total debt by $711 million in 97 and $561 million in 98 and also overstated its income by $45 million in 97 and $107 million in 98. ¶447. Enron, moreover, inflated its 97 net earnings by $51 million – almost 48% of its net income and 10% of recurring income – by refusing to correct improper accounting adjustments that the Andersen Partners identified during their 97 audit. ¶¶155(a), 517.

2. The Andersen Partners' False Statements About Enron's 99 Financial Statements

On 3/31/00, Enron issued its 99 Annual Report to Shareholders, which contained its 99 financial statements that Andersen and the Andersen Partners certified. ¶¶215, 219. Enron represented that it generated net income of $703 million in 98 and $893 million in 99, it earned EPS of $1.01 in 98 and $1.10 in 99, and total shareholders' equity exceeded $7 billion at year-end 98 and $9.5 billion at year-end 99. *Id.* These audited numbers were reported in Enron's 99 10-K, which contained Andersen and the Andersen Partners' purported clean opinions for 98 and 99. ¶¶221, 424.

The 10-K represented that Enron's debt was $7.4 billion in 98 and $8.2 billion in 99. ¶424. Andersen and the Andersen Partners consented to the incorporation of Enron's audited financial statements into Enron's registration statements and prospectuses. ¶¶425, 612, 899. Andersen and the Andersen Partners represented that Enron's financial statements for 98 and 99 complied with GAAP and they audited the statements in accordance with GAAS. ¶¶221, 899, 903-904.

But Enron has restated its certified financial statements for 98 and 99, and Andersen and the Andersen Partners have now admitted that their audited reports for these years "should not be relied upon." ¶¶955-956. Again, this reversal is an admission that Enron's financial statements were materially false when made. APB Opinion No. 20, at ¶13; *see Telxon*, 133 F. Supp. 2d at 1026 ("Telxon, itself, admitted its prior disclosures were materially misstated when it issued the restatements which gave rise to this litigation."). ¶¶384, 518, 955. Enron, for instance, overstated its shareholders' equity by $448 million in 98 and $833 million in 99 and understated its debt by $561 million in 98 and $685 million in 99 due to its failure to consolidate JEDI and Chewco. ¶¶384, 447. Enron also improperly accounted for its transactions with LJM and LJM2 – SPEs controlled by CFO Fastow – by improperly recording income from these entities or using them to conceal debt. LJM and LJM2 generated "earnings" for Enron of $229 million in the second half of 99, more than 50% of total earnings for the period. ¶448.

3. The Andersen Partners' False Statements About Enron's 00 and 01 Financial Statements

In 3/01, Enron filed its 00 10-K with the SEC, which contained Enron's 99 and 00 annual financial statements certified by Andersen and the Andersen Partners and their clean opinions that Enron's financials complied with GAAP. ¶292. The 10-K reported total revenues of $40.2 billion for 99 and $100.8 billion for 00, net income of $893 million for 99 and $1.3 billion for 00, and EPS of $1.18 for 99 and $1.47 for 00. The 10-K also reported total assets of $33.4 billion for 99 and $65.5 billion for 00, debt of $8.2 billion for 99 and $10.2 billion for 00, and shareholders' equity of $9.6 billion for 99 and $11.5 billion for 00. ¶424. These numbers were repeated in Enron's 00 Annual Report to Shareholders. ¶¶295-297. Andersen and the Andersen Partners certified that

Enron's 99 and 00 financial statements complied with GAAP and they audited these statements in accordance with GAAS. ¶¶292, 899, 903.

On 4/17/01, Enron reported robust quarterly results, announcing an 18% increase in EPS to $0.47 for 1stQ 01, a remarkable 281% increase in revenues to $50.1 billion, and a 20% increase in net income to $406 million. ¶316. On 7/12/01, Enron again reported better than expected quarterly results. Enron announced a 32% increase in EPS to $0.45 for 2ndQ 01 and a 40% increase in net income to $404 million. ¶328. Then on 10/16/01, Enron issued a press release announcing net income of $393 million for 3rdQ 01. ¶364. The Andersen Partners co-authored those press releases. ¶897. Andersen and the Andersen Partners gave express consent for their clean opinion of Enron's 00 annual financial statement to be included in this Registration Statement and Prospectus for the sale of $1.9 billion of Zero Coupon Convertible Notes. ¶899.

These statements were materially false when made, as evidenced by Enron's restatement and Andersen's and the Andersen Partners' admissions that their audit report for Enron's 00 annual finance statement "should not be relied upon." ¶956. By failing to consolidate JEDI's and Chewco's financial statements into its own, Enron misrepresented its income by $153 million in 99 and $91 million in 00 and understated its debt by $685 million in 99 and $628 million in 00. ¶¶339(a), (d), 447. Enron was concealing almost a billion dollars of debt through bogus transactions with the non-qualifying SPEs and improperly accounting for the Raptor equity transactions in violation of "basic" accounting principles. ¶¶339(c), 462, 951-52. Further, Enron was inflating the revenues by recognizing more than $110 million in fictitious revenue from its Blockbuster joint venture. ¶¶339(o), 521. Moreover, the financials included in the press releases also misrepresented the Raptors, which caused Enron's income to be distorted by hundreds of millions of dollars. ¶¶489-492, 951. The involvement of Andersen Partners in Enron's press releases is demonstrated by Duncan's testimony that he and his partners permitted Enron, in its 10/16/01 press release, to mischaracterize the $1.2 billion reduction in shareholder equity it took to reflect the Raptor vehicles. *United States v. Arthur Andersen, LLP*, No. H-02-121, 5/14/02 Trial Transcript at 1796:16-1799:25 ("Trial Tr."). Andersen has admitted its partners improperly accounted for these transactions. Speaking of the Raptor transactions, Andersen Partner Richard Corgel stated:

> What happened, on November 2nd and 3rd we did determine that the accounting for LJM1 Swap Sub was, in fact – that ***an error in judgment had been made on the part of our partner and that the accounting was wrong.***

5/28/02 Trial Tr. at 4678:12-15.

C. Even if the Andersen Partners Had Not Made False and Misleading Statements, Plaintiffs Have Adequately Alleged Those Defendants' Participation in a Scheme

Plaintiffs here have pleaded and are pursuing theories of recovery against the Andersen Partners that are well-grounded in the ***express language*** of §10(b) of the 1934 Act which states:

> Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly ...
>
> * * *
>
> (b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... ***any manipulative or deceptive device or contrivance*** in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[9]

15 U.S.C. §78j(b).

Rule 10b-5 promulgated by the SEC flows directly from the language of §10(b) itself and provides:

> §240.10b-5. Employment of manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

---

[9] Note that §10(b) itself does not expressly prohibit untrue statements of material facts or material omissions. This prohibition, like the prohibition against fraudulent schemes and fraudulent courses of business, is in Rule 10-5.

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

Not only does Rule 10b-5 forbid the making of "any untrue statement of a material fact," it also provides for scheme liability. Scheme liability is authorized by the text of §10(b). According to the Supreme Court, §10(b)'s prohibition of "any ***manipulative or deceptive device or contrivance***" necessarily encompasses any "***scheme to defraud***." In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court referred to the dictionary definitions of §10(b)'s words, to find that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice.'" *Id.* at 199 n.20 (quoting *Webster's International Dictionary* (2d ed. 1934)). The Court found that a "contrivance" means "'***a scheme, plan, or artifice***.'" *Id.* (quoting *Webster's International Dictionary*); *see also Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Clearly, "scheme" is encompassed in the broad language of §10(b).

Thus Rule 10b-5 – adopted by the SEC to implement §10(b) – makes it unlawful for any person "***directly or indirectly***" to employ "***any*** device, ***scheme***, or artifice ***to defraud***," "***to make any untrue statement[s]***," or to "***engage in any act, practice, or course of business which operates ... as a fraud or deceit upon any person***." 17 C.F.R. §240.10b-5. *See also U.S. Quest, Ltd. v. Kimmons*, 228 F.3d 399, 407 (5th Cir. 2000).

Prior to the Supreme Court's endorsement of the presumption of reliance based on the fraud-on-the-market theory for both misrepresentations and omissions in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Fifth Circuit had held that the theory applied ***only*** to omission cases and not misrepresentation cases. Thus, in some instances, securities plaintiffs sought recovery under subsection (1) and (3) of Rule 10b-5 alleging ***fraudulent scheme and course of business liability***. The Fifth Circuit expressly recognized the validity of these theories of recovery.

For instance, in *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987), plaintiffs sued under §10(b) and Rule 10b-5, claiming that the stock of Docutel was inflated due to false financial reports. According to plaintiff, Olivetti (which owned 46% of Docutel and controlled it) forced

Docutel to buy Olivetti's excess inventories at inflated prices so Olivetti could hide losses it was suffering. Docutel concealed this financial manipulation for some time but, when its auditors discovered the financial manipulation and forced a large inventory writedown, huge losses were disclosed and Docutel stock fell. The district court dismissed the complaint against Olivetti and Docutel because plaintiff failed to allege reliance on any of the false statements in Docutel's SEC filings, etc.

> But the fact that the complaint lists a number of documents filed with the SEC does not limit plaintiff's claim to subsection (2) only. For, as in *Shores*, plaintiff's lack of reliance on these documents does not resolve the claims made under 10b-5(1) and (3). ***We find that plaintiff's complaint properly alleges a scheme to defraud or course of business operating as a fraud for purposes of the first and third subsections; plaintiff's complaint, taken as a whole, alleges that Olivetti forced Docutel to take its worthless inventories, that this scheme or course of business was not disclosed, and that the effect was to defraud certain purchasers of Docutel.***
>
> * * *
>
> The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the marketplace; ***if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3).*** Thus, we conclude that the district court erred in its dismissal of the complaint as to plaintiff's claims under 10b-5(1) and (3).

Id. at 363-64; *accord Heller v. Am. Indus. Props. Reit*, Civ. No. SA-97-CA-1315-EP, 1998 U.S. Dist. LEXIS 23286, at *14 (W.D. Tex. Sept. 25, 1998) ("The first and third subsections, on the other hand, ***create a duty not to engage in a fraudulent scheme or course of conduct*** ....").

The Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading offering circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that offering circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme.***" *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981).

The fraudulent scheme and course of business involving Enron ***was worldwide in scope, years in duration and unprecedented in scale*** and required the skills and active participation of lawyers, bankers and accountants to help design, implement, conceal and falsely account for the deceptive acts and devices, manipulative contrivances and artifices they and Enron were using to

falsify Enron's reported profits and financial condition and to continue its fraudulent course of business.

The notion that *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), issued a broad edict that lawyers, bankers and accountants are immune from liability for their participation in complex securities frauds is nonsense. *Central Bank* expressly recognized: "The absence of §10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer ... or bank who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser ... relies may be liable as a primary violator under 10b-5.... In any complex securities fraud, moreover, there are likely to be multiple violators." *Id.* at 191. A scheme to defraud often will involve a variety of actors, and investors are entitled to allege "***that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme.***" *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998); *accord SEC v. First Jersey Sec. Litig.*, 101 F.3d 1450, 1471 (2d Cir. 1996); *In re Health Mgmt. Inc. Sec. Litig.*, 970 F. Supp. 192, 209 (E.D.N.Y. 1997); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 699-70 (C.D. Cal. 1994).

In *Central Bank*, a public building authority issued bonds to finance public improvements. Central Bank served as indenture trustee. The bonds were secured by liens covering property. The bond covenants required that the liened land be worth at least 160% of the principal amount of the bonds. Central Bank got a letter expressing fear that property values were declining and that perhaps the 160% value test was no longer met. The bank did nothing. Soon afterwards, the public building authority defaulted on the bonds. The bonds were not publicly traded. Central Bank, which had no commercial lending relationship with the municipal entity involved and which was not an investment bank, issued no analysts' reports about the issuer of the municipal bonds and thus made no statement and took no affirmative act that could have affected the trading price of the municipal bonds in issue. Clearly, this is a significantly different fact pattern from the Enron situation.

The *Central Bank* majority noted that their reasoning was "confirmed" by the fact that if they accepted the plaintiffs' aiding and abetting argument it would impose §10(b) and Rule 10b-5 liability when "at least one element critical for recovery" was absent, *i.e.*, reliance (511 U.S. at 180) (citing *Basic*, 485 U.S. 224, the Supreme Court's "***fraud-on-the-market***" decision) for the proposition that a plaintiff must show reliance to recover under 10b-5. "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements ***or actions***." 511 U.S. at 180. The Court found that allowing plaintiffs to "circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery as mandated by our earlier cases." *Id.* However, in this case, the alleged scheme and fraudulent course of business ***inflated*** the prices of Enron's ***publicly traded*** securities. ¶¶74, 418-424. Thus, the reliance element is not "***absent***" and the Supreme Court's prior decision in *Basic* is not circumvented – it is satisfied.

Central Bank denied recovery to victims of an alleged securities fraud who pleaded only one theory of recovery against the defendant bank – secondary liability dubbed "aiding and abetting." *Id.* at 191. However, the words aiding and abetting do not appear in §10(b) or Rule 10b-5. The Court said "***[T]he text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation ... that conclusion resolves the case.***" *Id.* at 177. The *Central Bank* plaintiffs did not, as plaintiffs do here, plead or pursue recovery under the theory that Andersen made false and misleading statements in audit opinions, registration statements or other documents issued to the public ***or*** employed acts and manipulative devices to deceive or engaged in a fraudulent scheme or course of business that operated as a fraud or deceit on purchasers of the securities in issue. In the words of the Court, the plaintiffs "concede that Central Bank did not commit a manipulative or deceptive ***act*** within the meaning of §10(b)." *Id.* at 191. Thus, because the *Central Bank* plaintiffs pursued a theory of recovery which found ***no support in the text of either the statute or the rule, they lost***.

Central Bank cannot mean that a defendant cannot be liable under §10(b) unless it made misleading statements because the Court rejected that argument in *United States v. O'Hagan*, 521 US. 642 (1997). The Eighth Circuit had held that, under *Central Bank*, "§10(b) covers only

deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely." *Id.* at 664. The Court reversed, holding that §10(b) does not require a defendant to speak. *Id.* Because §10(b) prohibits "'any manipulative or deceptive device or contrivance'" in contravention of SEC rules, this reaches "any deceptive device," whether or not the defendant spoke. *Id.* at 650. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), is consistent with *O'Hagan*. In *Superintendent of Ins.*, a ***unanimous*** Court upheld a §10b/Rule 10b-5 complaint involving a "fraudulent scheme" involving the sale of securities where ***no*** false statement was alleged because:

> ***There certainly was an "act" or "practice" within the meaning of Rule 10b-5 which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds.***

Id. at 9.

This Court has stated, citing *O'Hagan*, that:

> ***A defendant need not have made a false or misleading statement to be liable.***

In re Landry's Seafood Restaurants, Inc. Sec. Litig., No. H-99, slip op. at 9 n.12 (S.D. Tex. Feb. 20, 2001); *In re Waste Mgmt. Inc. Sec. Litig.*, Civ. No. H-99-2183, slip op. at 75 (S.D. Tex. Aug. 16, 2001)[10]; *BMC Software*, 183 F. Supp. 2d at 869.

That this reading of §10(b)/Rule 10b-5 is clearly correct is shown by a new ***unanimous*** Supreme Court decision – *SEC v. Zandford*, __ U.S. __, No. 01-147, 2002 U.S. LEXIS 4023 (June 3, 2002). In *Zandford*, the Court repeatedly cited with approval its seminal "***fraudulent scheme***" case *Superintendent of Ins.*, and reversed dismissal of a §10(b)/Rule 10b-5 complaint making the following key points:

- "***The scope of Rule 10b-5 is coextensive with the coverage of §10(b)*** ...." *Id.* at *7 n.1.

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[10] Due to the length of these opinions and the *Compaq* opinion cited in §F, *supra*, and the fact that this Court has access to them, they are not being attached to this brief.

- ***"[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b).*** *Id.* at *13.[11]

- Allegations that defendant "***engaged in a fraudulent scheme***" or "'***course of business that operated as a fraud or deceit***'" stated a §10(b) claim. *Id.* at *13, *14-*17.

Thus, *Central Bank* clearly – ***but merely*** – stands for the proposition that no aiding and abetting liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain "aiding and abetting" language. The decision in *Central Bank* is ***quite narrow***. By contrast, the language of §10(b) and Rule 10b-5 is ***very broad***. Also the purposes of §10(b) and Rule 10b-5 are remedial, intended to provide access to federal court to persons victimized in securities transactions:

> [T]he 1934 Act and its companion legislative enactments [including the 1933 Act] embrace a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry...." Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). As noted by the Fifth Circuit:

> [T]he Court has concluded that the Exchange Act and the Securities Act should be construed broadly to effectuate the statutory policy affording extensive protection to the investing public. *See Tcherepnin*, 389 U.S. at 336, 88 S. Ct. at 553. *See also* S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) (indicating legislative intent of the Securities Act to protect the public from the sale of fraudulent ***and speculative schemes***).

Meason v. Bank of Miami, 652 F.2d 542, 549 (5th Cir. 1981). "The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively." *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980).[12]

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[11] To the extent *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001), seems to require a statement be made about a company which is "publicly attributable to the defendant at the time that the plaintiff's investment decision was made," it is inconsistent with *Zandford*.

[12] The broad purposes of §10(b)'s prohibition of securities fraud and the Supreme Court's longstanding recognition of such broad purposes also support conspiracy and scheme liability. *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices."); *Affiliated Ute*, 406 U.S. at 152-53 (proscriptions of §10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry'") (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)); *Capital Gains Research*, 375 U.S. at 186 (§10(b) should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes"); *Superintendent of Ins.*, 404 U.S. at 11 n.7 ("'[We do not] think it sound to dismiss a complaint merely because the alleged

The Andersen Partners disclaim all responsibility for their fraudulent audit reports, claiming they are the sole representations of Andersen. But as a partnership, Andersen can only act through its partners and employees. *In re Securities Group*, 926 F.2d 1051, 1053 (11th Cir. 1991). David Duncan testified in Andersen's criminal trial, "I told them [Enron] that the firm made – makes the decision, and that includes all of us partners." 5/15/02 Trial Tr. at 2228:4-5. The false audit reports were the representations of the entire Enron auditing team, and the Andersen Partners are liable for them just like Andersen. *See Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 100-01 (2d Cir. 2001); *United States v. Natelli*, 527 F.2d 311, 319-23 (2d Cir. 1975); *United States v. Simon*, 425 F.2d 796, 798, 804-09 (2d Cir. 1969).

The audit reports themselves demonstrate they are the work of individual Andersen partners. The 00 report states:

> ***We have*** audited the accompanying consolidated balance sheet of Enron Corp. (an Oregon corporation) and subsidiaries as of December 31, 2000 and 1999, and the related consolidated statements of income, comprehensive income, cash flows and changes in shareholders' equity for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of Enron Corp.'s management. ***Our*** responsibility is to express an opinion on these financial statements based on our audits.
>
> ***We*** conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that ***we plan*** and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. ***We believe*** that ***our audits*** provide a reasonable basis for ***our opinion***.
>
> In ***our opinion***, the financial statements referred to above present fairly, in all material respects, the financial position of Enron Corp. and subsidiaries as of December 31, 2000 and 1999, and the results of their operations, cash flows and changes in shareholders' equity for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

¶903.

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scheme does not involve the type of fraud that is "usually associated with the sale or purchase of securities." We believe that §10 (b) and Rule 10b-5 prohibit ***all*** fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'") (emphasis in original) (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)).

Signing the Enron audit opinions on Andersen's behalf did not immunize the Andersen Partners from liability under the federal securities laws. *See Natelli*, 527 F.2d at 319-23; *Simon*, 425 F.2d at 798, 804-09. Nothing in *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), suggests that individual accountants cannot be primarily liable for their own false audit opinions. Insofar as *Wright* supports such a fantastic rule of law, it conflicts with *Central Bank*, which held that "[a]ny person or entity, including a lawyer, accountant, or bank, who ... makes a material misstatement ... on which a purchaser ... relies may be liable as a primary violator under Rule 10b-5...." 511 U.S. at 191.

Nor do defendants' authorities undermine plaintiffs' scheme allegations. Foremost, they conflict with the Supreme Court's *Zandford* opinion and this Court's ruling in *BMC*, 183 F. Supp. 2d at 904-05, and *Landry's*, slip op. at 9 n.12. And they are factually distinguishable. In *Shapiro*, the court found no §10(b) liability where a defendant accounting firm assisted and participated in concealing the principal's criminal background. *Shapiro v. Cantor*, 123 F.3d 717, 721 (2d Cir. 1997). In *Vosegerichian*, the court dismissed a complaint alleging that the defendant accounting firm merely advised on the accounting treatment of a transaction which was immaterial. *Vosegerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1377 (E.D. Pa. 1994). And a third case simply confuses scheme with conspiracy liability. *In re Hi/fn, Inc. Sec. Litig.*, Civ. No. C-99-4531-SI, 2000 U.S. Dist. LEXIS 11631, at *35 (N.D. Cal. Aug. 9, 2000).

D. The Andersen Partners Are Liable for False Statements They Played a "Significant Role" in Drafting

The Andersen Partners are also liable for the false statements in Enron's interim reports and press releases because they substantially participated in drafting them. ¶897. As Chief Risk Officer Richard Buy put it: "'Andersen's penetration or involvement in the company is probably different than anything I've experienced.... They are kind of everywhere and in everything.... [Andersen] actually participates in what we do.'" Lanthe Dugan et al., "On Camera, People at Andersen, Enron Tell How Close They Were," *Wall St. J.*, 4/15/02. There is no question that the Andersen Partners reviewed and edited Enron's press releases regarding quarterly results. Defendant Nancy Temple ordered Enron engagement partners to delete their conclusions that an imminent Enron press release

was false. ¶966. And as revealed during the Andersen trial, Tom Bauer stated that Houston partners "were on the phone with Chicago, with Andersen's national office and also with client management with regard to the characterization of certain language with respect to recurring or nonrecurring earnings or charges" for Enron's 3rdQ 01 press release. 5/29/02 Trial Tr. at 5041:9-13.

The Andersen Partners cannot use their role in the fraudulent financial statements and press releases as a shield. As noted by the Court in *BMC*, 183 F. Supp. 2d at 905, "'[p]rimary liability may be imposed "not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration"'" (quoting *First Jersey*, 101 F.3d at 1471). "[S]ubstantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements." *Howard v. Everex Sys.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); *see also ZZZZ Best*, 864 F. Supp. 960.

Several Texas district courts have adopted the substantial-participation test. Judge Sparks has written that primary liability would attach to purported non-speaking defendants "if a plaintiff explains how the defendant ratified or helped prepare another defendant's misleading public statement." *NetSolve*, 185 F. Supp. 2d at 699. Judge Folsom has ruled that an engineering firm can be held liable for false statements in reports that it "played a significant role in" preparing. *McNamara v. Bre-X Minerals, Ltd.*, Civ. No. 5:97-CV-159, 2001 U.S. Dist. LEXIS 4571, at *131-*132 (E.D. Tex. Mar. 30, 2001). And Judge Kent has ruled: "While Defendants are correct in asserting that there is no aider or abettor liability under Rule 10b-5, *see Central Bank* ... it is not factually clear that American Century did not have a more significant role in the alleged misrepresentations." *Young v. Nationwide Life Ins. Co.*, 2 F. Supp. 2d 914, 921 (S.D. Tex. 1998). The clear weight of authority from this Circuit holds that the Andersen Partners can be primarily liable for substantially participating in drafting Enron's false statements.

Indeed, the Ninth Circuit has held that an accounting firm may be found primarily liable under §10(b) for its "significant role" in preparing the misrepresentations of its client. *In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1995). Plaintiffs accused the accounting firm of violating §10(b) by participating in the drafting of two deceptive letters that its clients, not the

firm, mailed to the SEC. *Id.* at 628 n.3. The accounting firm's involvement with the letters included "'extensive review and discussions'" with the corporation and a "significant role in drafting and editing" them. *Id.* Based on the Supreme Court's decision in *Central Bank*, the district court dismissed the plaintiffs' claims, but the Ninth Circuit reversed. "[P]laintiffs' complaint clearly alleges," wrote the circuit court, "that [the accounting firm] is primarily liable under section 10(b) for the SEC letters" and evidence that it played a "significant role" "is sufficient to sustain a primary cause of action under section 10(b)." *Id.*

Likewise, a California district court concluded that primary liability under §10(b) existed against defendants who were "intricately involved" in the drafting of other defendants' misrepresentations. *ZZZZ Best*, 864 F. Supp. at 970. Defendant Ernst & Young argued, as Andersen does here, that "all the financial reports, press releases, supplements to the prospectus, etc., that were released to the public by Z Best and attributable only to Z Best or others, even if reviewed, edited or approved by E&Y, are not actionable against E&Y as violations of Section 10(b)/Rule 10b-5." *Id.* at 966. The trial court disagreed and found Ernst & Young could be held primarily liable under §10(b) and Rule 10b-5 where it was "intricately involved" in the creation of the deceptive statements. *Id.* at 970.

Nor does *Wright* undercut plaintiffs' substantial-participation claims. It misconstrues *Central Bank* as requiring reliance on the person who makes the misrepresentation. 152 F.3d at 175. But under any plain reading of *Central Bank*, a purchaser of securities need only establish that he relied on "a material misstatement." 511 U.S. at 191. Indeed, courts "presume[] that the plaintiff relied not on the defendant's fraudulent statements directly, ***but on the market's reflection of those fraudulent statements in the value of the stock***." *Fine v. American Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990).

E. The Andersen Partners Had a Duty to Correct Their False Audit Opinions

Professional standards require an auditor who discovers, even after the audit concludes, that his audit opinion was false or misleading to take appropriate steps "to prevent future reliance on his report." Codification of Statements on Auditing AU §561.06, Statement on Auditing Standards

("SAS") No. 1 (American Institute of Certified Public Accountants). Courts also impose a duty on accountants "'to take reasonable steps to correct misstatements they have discovered in previous financial statements on which they know the public is relying.'" *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986); *see Natelli*, 527 F.2d at 319. The Fifth Circuit has stated that "at least facially, it appears that defendants have a duty under Rule 10b-5 to correct statements if those statements have become materially misleading in light of subsequent events." *Rubinstein v. Collins*, 20 F.3d 160, 170 n.41 (5th Cir. 1994). The reasoning is rudimentary: "'The importance of the act of certifying is such that a continuing duty to disclose has been imposed where the auditor learns facts revealing that a certification believed correct when issued was actually unwarranted.'" *Rudolph*, 800 F.2d at 1044. "Where financial statements have been certified and released to the public, courts have imposed a continuous duty to disclose after-acquired information which casts doubt on the reliability of the certified figures ***with respect to the period covered by the audit.***" *Ingenito v. Bermec Corp.*, 441 F. Supp. 525, 549 (S.D.N.Y. 1977) (emphasis in original). This obligation is owed not only by Andersen but also by the Andersen Partners. *Natelli*, 527 F.2d at 319.

The 2/5/01 memorandum written after a conference call with senior Andersen partners shows that Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson were aware of Enron's dubious accounting treatment for the SPEs, knew Enron was distorting its balance sheet with the LJM off-balance transactions, and they found Enron's use of mark-to-market accounting to be abusive – indeed mere "intelligent gambling." ¶930. These facts show Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson knew their prior audit opinions were false and obliged them to disclose this information. *Rudolph*, 800 F.2d at 1044; *Natelli*, 527 F.2d at 319. Not only did they remain silent, they even consented for their 00 clean audit opinion to be incorporated into Enron's Registration Statement and Prospectus for $1.9 billion of Zero Coupon Convertible Notes sold in 7/01. ¶¶336, 899. "In connection with a registration statement, an accountant is under an additional obligation to conduct a reasonable inquiry, but not an audit, to discover whether events subsequent to the audit period up to the effective date of the registration require disclosure in order to maintain the integrity of the portrayal." *Ingenito*, 441 F. Supp. at 549.

There is no evidence Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, or Swanson met his continuing obligation.

Nor did Cash, Odom, or Swanson make a public disclosure or qualify the Enron audit opinions after Sherron Watkins warned Andersen, on 8/20/01, about accounting irregularities at Enron. ¶¶933-934. Watkins advised a former colleague, who in an emergency meeting relayed the information to Cash, Odom, and Swanson, that Enron's financial disclosures regarding the LJM entities, SPEs controlled by Fastow – as well as by Enron's Chairman – were perplexing and incomplete. ¶933. She disclosed that Enron was omitting its capital-stock contributions to LJM partnerships from its books and revealed that partnership equity was distributed to LJM investors, including CFO Fastow, soon after the SPE was formed. *Id.* Cash, Odom, and Swanson disclosed none of these facts to investors nor cautioned them that their clean (unqualified) audit reports were false. Therefore, they are liable under Rule 10b-5 for their silence. *Rudolph*, 800 F.2d at 1044; *Natelli*, 527 F.2d at 319. And it "is the jury's role to determine the exact date on which [their] failure to correct ... previous [false audit opinions] became severely reckless." *Bre-X*, 2001 U.S. Dist. LEXIS 4571, at *168-*169.

F. Plaintiffs Have More Than Adequately Alleged the Andersen Partners' Scienter

1. Standard

In this Circuit, plaintiffs "must plead specific facts constituting strong circumstantial evidence of conscious misbehavior or recklessness and motive and opportunity may be considered as a factor in determining whether a strong inference has been raised." *Abrams v. Baker Hughes Inc.*, Civ. No. 01-20514, 2002 U.S. App. LEXIS 9565, at *7 (5th Cir. May 21, 2002). And the Court should "consider whether all facts and circumstances 'taken together' are sufficient to support the necessary strong inference of scienter on the part of the plaintiffs." *Id.* at *12. Despite the Andersen Partners' attempts to isolate them, plaintiffs' scienter allegations are so strong that any one suffices. Taken together, as they must be, they present overwhelming evidence of the Andersen Partners' deception.

2. The Andersen Partners Knowingly Committed Fraud

a. The Andersen Partners Knew Enron Improperly Hid Debt and Inflated Income Through Use of Captive SPEs

Andersen Partners participated in all areas of Enron's SPE transactions, including structuring and reviewing the details of the deals. ¶942. For advice it rendered to the LJM entities and Chewco, Andersen billed $5.7 million, a sum that corresponds to an incredible ***28,000 hours*** of consulting and accounting work based on an average hourly rate of $200. *Id.* Andersen billed $80,000 for the month when the Chewco transaction was structured. ¶946. In 00 alone, Andersen billed Enron at least $335,000 for its work on the Raptor transactions. ¶951. As reported by Audit Committee Chairman Robert Jaedicke, Andersen notified the Audit Committee during a 10/99 meeting that it "had spent considerable time during the third quarter reviewing a joint venture [Enron] was forming to assist in monitoring investments." Ex. 14.[13] Accounting decisions relating to the captive SPEs were made by Houston partners as well as by partners in Andersen's National Office Group and the Professional Standards Group – PSG, which included Neuhausen, Petersen, and Stewart. ¶¶93, 940, 947.

(1) The Andersen Partners Knew the Raptor Transactions Were Fraudulent

The Andersen Partners knew the Raptor transactions were deceptive devices when they certified Enron's financial statements as complying with GAAP. Even a cursory review reveals the Raptor transactions violated several fundamental accounting precepts. ¶¶951-952. The substance of the Raptors transactions effectively allowed Enron to report net income and gains on its income statement that were backed wholly by Enron stock or contracts to receive Enron stock, which the Raptors held. ¶¶445-446. In essence, these transactions conjured income from thin air. *Id.* According to Lynn Turner, the former Chief Accountant of the SEC, "'What we teach in college is that you don't record equity until you get cash for it, and a note is not cash .... ***It's a mystery how both the company would violate, and the auditors would miss, such a basic accounting rule, when the number is one billion dollars***." ¶951. The "simplicity of the GAAP principles violated in" the

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[13] All exhibit references are to plaintiffs' Appendix.

Raptor transactions "lend[s] ... probative weight to Plaintiffs' allegations that the GAAP violations in this case raise a strong inference of scienter." *In re MicroStrategy Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 652 (E.D. Va. 2000). In this Court the analysis is elementary: the "simpler the violations of GAAP, the more obvious they are and the inference of scienter becomes more probable." *Waste Mgmt.*, slip op. at 156; *accord MicroStrategy*, 115 F. Supp. 2d at 635.

Andersen internal e-mail reveal that Cash, Lowther, Odom, and Stewart were deeply involved in the accounting decision for the Raptors and knew that PSG Partner Bass thought that Enron's accounting for the Raptor vehicles was improper. ¶¶929, 952(c). Moreover, during the 2/5/01 client-retention call, which occurred almost three weeks before they certified Enron's 00 financial statements, Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson expressly discussed the severe problems with Enron's treatment of the Raptors and similar transactions. ¶930. Then on 3/4/01, Bass e-mailed Stewart opposing Enron's accounting for the Raptor transactions. ¶932. But these defendants still allowed their unqualified opinion to be included in Enron's 00 10-K, which is compelling evidence they acted with scienter. *Zonagen*, 267 F.3d at 408; *see Fla. State Bd. of Admin. v. Green Tree*, 270 F.3d 645, 665 (8th Cir. 2001) ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.").

And the removal of Bass soon after he objected to Enron's accounting for the Raptor transactions strengthens the inference of fraud. This decision, as Bass testified during Andersen's trial, was made by Andersen senior management. 5/10/02 Trial Tr. at 1308:11-14. Defendant Stewart, Bass' supervisor in the PSG, knew Enron ordered his removal. 5/30/02 Trial Tr. at 5391. Bass' removal provided a glaring red flag, which a "prudent auditor," in Stewart's position in particular, would have investigated. *See Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1340 (N.D. Ga. 1998).

(2) The Andersen Partners Knew the LJM Transactions Were Fraudulent

Cash, Neuhausen, and Stewart knew that Enron's transactions with the LJM Partnerships served no economic purpose other than concealing debt and losses and enriching Fastow and other Enron executives. ¶¶948, 950. Specifically they knew former CFO Fastow and other Enron executives controlled LJM and LJM2 and reaped tens of millions of dollars in management fees and partnership profits. ¶¶944, 948, 949(a) and (d), 950. The private-placement memorandum for LJM2, which they read in the course of performing hundreds – if not thousands – of hours of work on the LJM partnerships, revealed that Enron executives Fastow, Kopper, and Glisan owned and controlled LJM2's general partner, and LJM2 was managed on a daily basis by Enron executives. ¶¶948-949.

The private-placement memorandum disclosed that Enron retained significant economic and operating interests in the LJM2 investments and trumpeted the prospects of superior returns due to the inside information its general partners could obtain from their positions with Enron. ¶¶948, 950. The returns to the LJM2 investors were huge – as much as 2,500% on one deal and 51% overall in the first year of the partnership. Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicion of Fraud," *New York Times*, 4/24/02. Defendant Skilling, Enron's former CEO and President, recently told investigators such gargantuan returns were possible only because of fraud. *Id.* In addition, the private-placement memorandum revealed that Enron was carrying at least $17 billion in assets and associated liabilities off its balance sheet – an astounding 33% of its total assets. ¶¶948, 949(b). Cash, Neuhausen and Steward should have thoroughly investigated the business purpose and substantive reasons for accounting for so much of Enron's total assets on an "off-balance sheet" basis. ¶949(b). There is no evidence that the requisite investigation was even undertaken.

Assets "sold" to LJM2 were quickly repurchased after year-end by Enron at a substantial increase in price, though the value of the assets had often declined. ¶949(e). Enron, for example, repurchased the Nowa Sarzyna Power Plant within four months. ¶471. Enron dumped several underperforming investments, such as CLOs from Enron North America, the Nowa Sarzyna plant, and MEGS, into LJM2 within the last 10 days of the 99 reporting year. ¶¶469-472. The "fortuity"

of these "sales" for Enron raised serious questions about the legitimacy of the transactions. *See Telxon*, 133 F. Supp. 2d at 1031.

By early 99, moreover, the Andersen Partners were characterizing Enron as high risk in their "Selected Observations – 1998 Financial Reporting," an opinion presented by Bauer and Goddard to the Enron Audit Committee. Ex. 17. During the 2/7/99 Enron Audit Committee meeting, David Duncan – in the presence of Bauer and Goddard – characterized Enron's SPEs as "push[ing] limits" and having "a high 'others could have a different view' risk profile." Ex. 18. "Allegations of obvious 'red flags' or warning signs that financial reports are misstated, [such as these,] ... can give rise to a strong inference of fraudulent intent." *Chu*, 100 F. Supp. 2d at 824.

By 12/99, PSG partner Bass had written Neuhausen and Stewart to oppose Enron's accounting for a certain SPE. ¶¶913, 928. One month before Andersen and the Andersen Partners certified Enron's 99 financial statements, Bass, in a February e-mail to Neuhausen and Stewart, described several Enron transactions involving an SPE – "this whole deal looks like there is no substance," which in accounting jargon means the transactions were bogus. ¶929; *see also* Codification of Statements on Auditing Standards, AU §334.02 ("the auditor should be aware that the ***substance*** of a particular transaction could be significantly different from its form and that the ***financial statements should recognize the substance*** of particular transactions rather than merely their legal form"). Three days later, Bass criticized another Enron SPE in an e-mail to Stewart for having no real substance and disapproved a transaction in which Enron was set to gain from the appreciation of the capital stock it contributed to the SPE. Defendants Bauer and Cash were privy to these conclusions. ¶929.

Three weeks before Andersen and the Andersen Partners released their clean opinion for Enron's 00 financial statements (issued on 2/23/01), senior partners from the Andersen Chicago and Houston offices met to discuss Enron's serious accounting improprieties. ¶¶903, 930. On 2/5/01, Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson met via teleconference to determine whether to retain Enron as a client. ¶930. A follow-up memo from this meeting reveals the partners identified and discussed numerous irregularities in Enron's accounting; they questioned Enron's aggressive structuring of deals as well as the propriety of the LJM

transactions and the deceptive impact they had on Enron's income statement; they discussed Fastow's conflict of interest as Enron CFO and LJM fund manager; and they expressed concern over Enron's complete dependence on its current credit rating to remain solvent. *Id.* Nonetheless, they agreed to issue a clean audit opinion a few weeks later – in the face of these glaring red flags – because of Enron's potential to grow into a $100 million a year client. ¶¶912, 931. These allegations are more than sufficient to plead a strong inference of scienter. *Zonagen*, 267 F.3d at 408; *see Baker Hughes*, 2002 U.S. App. LEXIS 9565, at *19 (finding scienter where "plaintiffs ... point[] to ... particular reports or information – available to defendants before the announced financial restatements – that are contrary to the restatements"); *Bovee v. Coopers & Lybrand C.P.A.*, 272 F.3d 356, 362 (6th Cir. 2001) (finding that "specific allegations that [auditor's] own internal assessments of [the company] showed [it] to have knowledge of the risk that [the company] was misleading" may support a strong inference of scienter); *Fine*, 919 F.2d at 297 (denying summary judgment where auditor admitted in work papers "that their 'audit team could not accept ASK's position that the existing reserve was adequate'" but stated in public "that it was 'unable to determine the adequacy of the provision for uncollectible accounts'").

Documents offered by the United States in the Andersen criminal trial confirm the Andersen Partners knew that fraud pervaded the LJM transactions. After Fastow approached him to create the LJM partnership, Duncan consulted with Neuhausen. Neuhausen derided LJM in a 5/28/99 e-mail stating, "conflict[s] of interest galore. Why would any director in his right mind ever approve such a scheme?" 5/9/02 Trial Tr. at 1056:5-6. Neuhausen warned that the PSG would be "very uncomfortable" with Enron recording income from selling assets to LJM. *Id.* at 1060:10.

The Andersen Partners suggest that the 2/00 e-mail from PSG partner Bass merely demonstrates a healthy "debate among auditors." Mot. at 16. If true, Andersen would never have removed Bass from his oversight position. ¶913. Nor would Richard Causey, Enron's Chief Accounting Officer, have pressured CEO Berardino and other senior Andersen management to remove Bass from the Enron account. *Id.* Causey insisted that Andersen replace Bass because he was too "rule-oriented" and "wasn't very flexible at times in some of the accounting matters." 5/9/02 Trial Tr. at 1115:8, 11-12. Moreover, as part of her effort to conceal Andersen's and the Andersen

Partners' active participation in the Enron fraud, Nancy Temple ordered e-mail relating to Bass' disagreements with Enron's accounting practices deleted. ¶965. These facts suggest far more than a debate among auditors. In any event, the task of resolving contrary accounts is reserved for the jury. *See Haack v. Max Internet Communs., Inc.*, Civ. No. 3:00-CV-1662-G, 2002 U.S. Dist. LEXIS 5652, at *25 (N.D. Tex. Apr. 2, 2002) ("the court will not entertain this argument" at the pleading stage "because it concerns a factual dispute").

Incredibly, the Andersen Partners argue that the Bass e-mail allegations fail to show "what knowledge any of these individuals had that would have led them to conclude the accounting was improper." Mot. at 18. They ignore one of plaintiffs' strongest allegations – that Bass warned Neuhausen and Stewart that several Enron SPE transactions "looks like there is no substance to them." ¶929. Neuhausen and Stewart knew that the substance of a transaction, not its legal form, determines how it is accounted for. *See* AU §334.02. Moreover, Bass was a recognized expert in accounting principles, having been entrusted with an oversight position with Andersen's PSG group. ¶928. He served as a staff member of FASB, the body which establishes GAAP. 5/10/02 Trial Tr. 1209-1210. As such, his opinion about Enron's accounting irregularities carried great weight and a prudent accountant could not have disregarded once, let alone several times as did Neuhausen and Stewart.

The Andersen Partners point to self-serving language in the memorandum memorializing the 2/5/01 call as evidence that Bauer, Bennett, Goodard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson properly vetted the risks posed by Enron. But the memorandum makes clear that the engagement risks identified – including Enron's abuse of mark-to-market accounting – or mere "intelligent gambling" – were viewed manageable only because the Andersen Partners expected Enron to grow into a $100 million per year dollar. This does not show good faith, as the Andersen Partners would have the Court believe. Perhaps a jury could find their interpretation on the memorandum credible. But at this stage, the Court cannot accept their "alternative explanation," even if found "more reasonable." *Oran*, 226 F.3d at 285 n.5.

The Andersen Partners attempt to neutralize the damaging allegations about the 2/05/01 client-retention call by accusing plaintiffs of invoking the group-pleading doctrine. Plaintiffs do no

such thing. Rather, plaintiffs set forth the Andersen Partners' knowledge, their participation in the fraudulent scheme, and the false statements for which they, as partners of the firm, are responsible. The group-pleading doctrine, by definition, refers to ***false statements***. As discussed above, "[a] defendant need not have made a false or misleading statement to be liable." *Landry's*, slip op. at 9 n.12.

(3) The Andersen Partners Knew Chewco and JEDI SPEs Were Fraudulent

Significant red flags surrounded Chewco's creation, which raised serious questions about the legitimacy of the entity. ¶946. Bauer and Cash knew that Chewco's general partners were senior financial employees at Enron. ¶¶942, 946(a); Hearing of the Oversight Investigations Subcommittee of the House Energy & Commerce Committee, Testimony of Thomas Bauer, 2/7/02 ("Bauer Congressional Testimony"). Under AU §334, Bauer and Cash were required to confirm the transaction was genuine and determine if the Chewco deal received approval from Enron's board or senior officers. ¶943. Minutes from the 11/5/97 Enron Executive Committee meeting, which Bauer and Cash reviewed, revealed that Enron itself had guaranteed over ***$600 million*** in loans so Chewco could acquire the limited partner's interest in JEDI. Ex. 21. These facts required Bauer and Cash to scrutinize the nonconsolidation of Chewco and JEDI. *See* ¶943. Failing in this duty, their "'egregious refusal to see the obvious, or to investigate the doubtful'" raises a strong inference of scienter. *In re Complete Mgmt. Sec. Litig.*, 153 F. Supp. 2d 314, 334 (S.D.N.Y. 2001); *see Kinney*, 170 F. Supp. 2d at 180 (auditor's "failure to 'investigate the doubtful' gives rise to a strong inference of scienter"); *Bre-X*, 2001 U.S. Dist. LEXIS 4571, at *141 ("The methods to demonstrate extreme departure from the standards of ordinary care may include ... 'an egregious refusal to see the obvious, or to investigate the doubtful.'").

The Andersen Partners knew Enron CFO Fastow – through executive Michael Kopper, Fastow's agent – controlled Chewco. Consequently, FASB 94 required Enron to consolidate Chewco (and JEDI) into its financial statements. ¶¶430-432, 946(a). Even applying the purported 3% rule of EITF 90-15, they knew Enron's accounting for Chewco was fraudulent. EITF 90-15 requires, at a minimum, an independent, at risk equity contribution of 3% by an independent party. *See* ¶439.

Bauer testified, "[a]ccording to Mr. Glisan, the second component of Chewco's third party equity would come from wealthy individual investors, who, with the exception of Mr. Kopper, would be independent of Enron." Bauer Congressional Testimony. But "wealthy individual investors" did not buy into Chewco. Instead, Chewco's purported general partners – entities controlled by Enron executive Kopper – borrowed $11.4 million from Barclays Bank to fund the 3% stake. ¶439. The Andersen Partners knew this because Enron provided them with the documents establishing a $6.6 million reserve that Barclays required – and which JEDI, in effect only Enron by now, paid. ¶¶439, 946(b). Chewco's general partners thus "contributed" a mere 1.5% of total capital. ¶439. Workpapers for the Chewco transaction reveal that the Andersen Partners were aware of a distribution from JEDI. *See* Powers Report at 53. And "Bauer had complete access to all the documents." Ex. 15. As a consequence, Enron's fraudulent treatment of Chewco was "so obvious that [the Andersen Partners] must have been aware of it." *Zonagen*, 267 F.3d at 408; *accord BMC*, 183 F. Supp. 2d at 867 n.18.

b. The Andersen Partners Knew Enron's Accounting Treatment for Braveheart Was Improper and Knew Enron Abused Mark-to-Market Accounting

The Andersen Partners knew the Braveheart transaction was a phony deal concocted by Enron to generate fictitious revenue. Braveheart failed to qualify as a true independent SPE because Enron guaranteed the vast majority of its seed capital. ¶522. Accordingly, Braveheart should have been consolidated and Enron should not have recognized revenues from the sale of its Blockbuster interest to it. ¶936. The value Enron ascribed to its interest in Blockbuster ($124.8 million), moreover, was imaginary. ¶¶339(o), 522. Enron employees divined a future cash flow stream from the joint venture without ever conducting any substantive analysis. *Id.* It was simply a guess – and not even an educated one. The sale of Enron's interest to the captive Braveheart occurred although Blockbuster lacked the necessary licenses to distribute movies to residences. *Id.* Stewart knew that Enron's recognition of $110 million in revenue from this transaction was improper because, on 3/4/01, PSG Partner Bass e-mailed him to express his outrage with Enron's accounting treatment for the Braveheart deal. ¶932. So did Roger Willard, who devised the accounting treatment for Braveheart. *See* 5/30/02 Trial Tr. at 5394:5-19.

Employees in Enron's broadband discussion were astonished with the Andersen Partners' acceptance of the Braveheart accounting. "'Nobody in the division would comprehend how [Enron executives] got Andersen to sign off on'" the deal, observed a former Enron senior executive, because Braveheart was not "'doing business on any scale even close to those numbers.'" ¶936. The Andersen Partners' conduct certainly displays, at a minimum, "an 'egregious refusal to see the obvious, or to investigate the doubtful.'" *Complete Mgmt.*, 153 F. Supp. 2d at 334; *accord*, *Kinney*, 170 F. Supp. 2d at 180.

The Andersen engagement team also ignored Enron's abuse of mark-to-market accounting, used to accelerate earnings from a multi-year contract into the current quarter. ¶534. Although mark-to-market accounting should be applied ***only*** where the revenue streams from a contract are predictable and based on historical records of similar transactions, Enron applied the methodology to most of its businesses, even where it lacked historical data about revenues such as with its broadband transactions and retail and commercial energy demand-side-management contracts. ¶¶534, 544-548. During the 2/05/01 client-retention call, attended by Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson, senior Andersen partners described Enron's mark-to-market accounting as mere "intelligent gambling." ¶930. And defendants Neuhausen, Petersen, and Stewart continued to sign off on this dubious practice though Enron's abuse of it became common. ¶¶938-940. Repeated violations of accounting principles reinforce the inference of fraud. *Fine*, 919 F.2d at 297.

Plaintiffs do not suggest that use of mark-to-market accounting is always improper. At issue is Enron's abuse, not use, of this methodology. *See, e.g.*, ¶938. Enron abused mark-to-market accounting by accelerating projected revenue streams for which it had no historical data. *See* ¶¶534, 544-548. Neuhausen, Petersen, and Stewart knew mark-to-market accounting pervaded Enron's books. ¶¶939-940. Stewart knew it was mere "intelligent gambling." ¶930. And the CC does identify individual transactions in which the Andersen Partners improperly approved mark-to-market accounting. For example, Stewart was warned by Bass that the accounting for Braveheart was improper, and yet Andersen approved of it. ¶¶932, 936.

3. The Andersen Partners Knowingly Ignored Material Adjustments in Enron's 97 Audit

During their audit of Enron's 97 financial statements, the Andersen Partners compiled $51 million of adjustments for improper accounting by Enron, which together approximated 50% of Enron's total net income ($105 million) and 10% of recurring net income for the year. ¶¶517, 955. Enron refused to make the corrections they urged it to make, because to do so would have slashed its 97 net income in half. *Id.* Reluctant to jeopardize millions in fees from Enron, Andersen and its partners truckled and never insisted the adjustments be made as GAAS required. ¶¶955, 957. The sheer magnitude of the adjustment, however, precluded Andersen and its partners from simply ignoring them. ¶955. They instead calculated the $51 million as a percentage of "unrealized earnings" rather than net income. *Id.* These "core business" matters of the 97 audit – identified adjustments representing ***nearly half*** of Enron's net income – are so important that it "can be inferred" that all the partners on the Enron engagement knew of them. *Kurtzman v. Compaq Computer Corp.*, No. H-99-779, slip op. at 38 (S.D. Tex. Apr. 1, 2002).

4. The Andersen Partners' Attempted Cover-up of the Fraud and Their Intentional Destruction of Documents Raises a Strong Inference of Scienter

On 8/20/01, Sherron Watkins, an Enron Vice President and former Andersen accountant, warned Andersen audit partner James Hecker about the numerous accounting irregularities at Enron. ¶¶933, 963. The next day, Hecker convened an emergency meeting with defendants Cash, Odom, Swanson and others to discuss Watkins's concerns about "the propriety of accounting for certain related-partner transactions" with the LJM partnerships. ¶933. By mid-September, senior audit specialists in Chicago, including Stewart, had concluded that Andersen approved much of Enron's fraudulent accounting. ¶964.

As soon as the Enron fraud began to unravel, Andersen partners began debating how best to alter memoranda and work papers to minimize potential exposure. ¶964. Nancy Temple, an Andersen in-house lawyer in Chicago, sent an 10/01 e-mail, which reminded Andersen personnel to abide by the document retention and destruction policy – a code for destroying all damaging documents. ¶964. As Patricia Grutzmacher testified in the Andersen criminal trial, Tom Bauer, in

a 10/23/01 meeting, confessed "that if he ever talked to us about getting rid of documents, it would always be along the lines of compliance with the firm's document-retention policy." 5/21/02 Trial Tr. at 3243:4-6. In accordance with Temple's directions, senior auditors in Chicago began deleting e-mail related to Enron, including messages regarding Carl Bass' objections with Enron's accounting during the Class Period. ¶965. Nancy Temple even insisted that partners delete e-mail they had retained to support their own work. *Id.*

After conferring with defendants Dreyfus and Friedlieb, Temple encouraged the Enron audit team to "add back" Bass' previously-omitted criticisms in order to create the impression the Andersen partners exercised appropriate diligence. ¶966. To conceal her participation in the fabrication of documents, Nancy Temple ordered the audit partners to delete her name from fictitious memoranda; they were supposed to represent the conclusions of Duncan and other Enron auditors. Temple also instructed them to delete their conclusions that Enron's soon to be released financial statement was misleading. *Id.* Forty minutes later, Temple wrote to defendant Odom, director for the Gulf Coast Market Circle, instructing the Enron engagement team to "comply" with Andersen's documentation and retention policy. *Id.* Odom forwarded the e-mail message to Duncan. *Id.* Odom had previously told Andersen accountants, "'If documents are destroyed and litigation is filed the next day, that's great'.... 'We've followed our own policy, and whatever there was that might have been of interest to somebody else is gone and irretrievable.'" ¶965. Temple refuses to testify about these events, as her testimony would incriminate her. ¶68. A jury is "entitled to draw on adverse inference from the fact that [Temple] has asserted [her] Fifth Amendment rights in a civil case." *SEC v. Cook*, No. 3:00-CV-272-R, 2001 U.S. Dist. LEXIS 2601, at *12 n.4 (N.D. Tex. Mar. 8, 2001).

On 10/22/01, Enron management notified Duncan and another auditor that a subpoena from the SEC was imminent. The next day, Bauer, who also has refused to testify, stressed the exigency of bringing the Enron files into "compliance," and Roger Willard, another Enron engagement partner, pushed his managers and staff to ensure "compliance" with Andersen's document retention policy. ¶966. Bauer and Duncan called defendant Jones in London and instructed him to get in "compliance" with the policy, which he did. 5/30/02 Trial Tr. at 5320:19-5321:9, 5364:10-18. And

Chairman Berardino knew of the destruction of Enron-related documents. ¶966. At least 20 trunks of Enron-related documents were shredded in Houston, with Andersen's London and Portland offices also joining the document destruction. *Id.* The deliberate destruction of documents, orchestrated by Bauer, Berardino, Dreyfus, Friedlieb, Jones, Temple, and Willard, not only is "probative of a culpable state of mind," *MicroStrategy*, 115 F. Supp. 2d at 641, but also entitles plaintiffs to an adverse inference at trial. *See Vick v. Texas Employment Com.*, 514 F.2d 734, 737 (5th Cir. 1975) (permitting "adverse inference to be drawn from [the] destruction of records ... predicated on bad conduct of the defendant[s]").

Bauer and Odom claim their document destruction was innocuous. Bauer's account conflicts with the testimony of Patricia Grutzmacher. It is particularly dubious now that Bauer has refused to testify in the Andersen criminal trial. And Odom's assertion rings hollow, given his zealous support of Andersen's document retention program: "'If documents are destroyed and litigation is filed the next day, that's great'.... 'We've followed our own policy, and whatever there was that might have been of interest to somebody else is gone and irretrievable.'" ¶965.

The Andersen Partners suggest that intentional document destruction alone is insufficient to support a claim for securities fraud. As this Court stated in *BMC*, a "defendant need not have made a false or misleading statement to be liable." 183 F. Supp. 2d at 869. Section 10(b) liability attaches because the document destruction is a "deceptive act in furtherance of the scheme" to defraud. *Cooper*, 137 F.3d at 625.

Finally, the Andersen Partners characterize the Sherron Watkins allegations as irrelevant. Sherron Watkins' statements revealed that the Enron audit reports were false when issued. Cash, Odom, and Swanson, all of whom knew of Watkins' revelations, were obliged to correct the false audit opinions. *See Rudolph*, 800 F.2d at 1044. And it "is the jury's role to determine the exact date on which [their] failure to correct [the] previous [audit opinions] became severely reckless." *Bre-X*, 2001 U.S. Dist. LEXIS 4571, at *168-*169. Moreover, the Watkins allegations are probative of scienter with respect to Enron's 10/16/01 press release, which the Andersen Partners reviewed. ¶897; 5/14/02 Trial Tr. at 1840.

5. The Magnitude of Enron's Restatements Raises an Inference of Scienter

The sheer magnitude of Enron's restatements further strengthens the inference that the Andersen Partners acted with scienter. *See, e.g.*, *Green Tree*, 270 F.3d at 666 ("the sheer size of the $390 million write-down adds to the inference that the defendants must have been aware the problem was brewing"); *Haack*, 2002 U.S. Dist. LEXIS 5652, at *24 ("the overstatement of significant revenues can support the claim that the defendants acted in a severely reckless manner"); *Leslie Fay*, 835 F. Supp. at 175 ("In cases where small accounting errors only ripple through the corporate books, a court may conclude ... that an accountant's failure to discover his client's fraud was not sufficiently reckless to sustain a 10b-5 claim. On the other hand, when tidal waves of accounting fraud are alleged, it may be determined that the accountant's failure to discover his client's fraud raises an inference of scienter on the face of the pleading."). Enron restated its annual financial statements for 97-00. ¶384. As a consequence of the restatements, Enron slashed from its books $600 million of previously recorded profits and $1.2 billion in shareholder equity. *Id.* In 97 alone, for example, Enron overstated its recurring net income by $96 million and shareholders' equity by $313 million, and understated debt by $711 million. *Id.* In 00, Enron overstated its recurring net income by $132 million and shareholders' equity by $1.2 billion, and understated its debt by $628 million. *Id.*

The impact from the 98 and 99 restatements was just as devastating. *Id.* Enron's "GAAP violations and the subsequent restatements are of such a great magnitude – amounting to a night-and-day difference with regard to" Enron's debt and shareholder equity "as to compel an inference that fraud or recklessness was afoot." *MicroStrategy*, 115 F. Supp. 2d at 637; *see Carley Capital*, 27 F. Supp. 2d at 1339-40 ("While alleging a misapplication of Generally Accepted Accounting Principles standing alone is insufficient, such allegation when combined with a drastic overstatement of financial results can give rise to a strong inference of scienter."). *See also In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1345 (S.D. Fla. 1999); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1256 (N.D. Ill. 1997).

6. The Andersen Partners Disregarded Other Red Flags at Enron

The Andersen Partners also knew the potential for fraudulent financial reporting by Enron was great. Enron operated hundreds of Byzantine partnerships in foreign countries where complete secrecy is observed. ¶922. Enron devised numerous related-party transactions whose sole purposes were to conceal debt. *Id.* The Andersen Partners knew that many of the Fastow-controlled partnerships were formed in offshore tax havens. *Id.* The ownership, complexity, interrelationship, and locales of the countless partnerships was more than enough to set off alarm bells. Enron's 5/18/00 client-retention checklist, which Goddard, Lowther, Odom, and Swanson signed, noted that "the Company's personnel are very sophisticated and enter into numerous complex transactions and are often aggressive in structuring transactions to achieve financial reporting objectives." Ex. 19. Thus, the Andersen Partners actually knew Enron was structuring transactions not for business purposes but "to achieve financial reporting objectives." This mirrors risk factors indicating the risk of fraud was great. ¶921. Goddard, Lowther, Odom, and Swanson also knew Enron posed a "very significant" accounting and financial reporting risk, with "very significant" management pressures. Ex. 19; ¶926. And no later than 2/7/99, Bauer was aware of Enron's substantial engagement risks. Ex. 18. These allegations support an inference of fraud. *See Bovee*, 272 F.3d at 362 n.8 (finding accountant's assessment of client as the highest risk is relevant to determining scienter).

The grave risks posed by the Enron engagement were well-known throughout Andersen. Andersen Houston partner Hecker, who did not even work on the Enron engagement, declared:

> A. I had heard rumors that ENRON was a very aggressive client. They were on the leading edge of business, they were leading edge in accounting and they were [sic] have a very complex client. They were demanding and very hard to keep up.
>
> * * *
>
> Q. Did you also understand that ENRON pressured Andersen into accounting for transactions the way ENRON wanted to?
>
> A. Yes

5/8/02 Trial Tr. at 819:6-9, 823:16-18. Defendant Jones added:

> Q. Did you also have a view as to the disclosure philosophy of ENRON in terms of what they would disclose in their financial statements?
>
> A: Yes.

Q: And what was that?

A: Minimalistic

Q: Did you have, from time to time, significant disagreements with people at ENRON?

A: Yes.

Q: Did you get a lot of push-back?

A: Daily.

Q: Were there certain people who gave you a lot more push-back than others?

A: Yes.

Q: Gave you a hard time?

A: Yes.

Q: Were there people that screamed at you?

A: I was screamed at on a few occasions.

5/30/02 Trial Tr. at 5356:1-18. Clearly, the Andersen Partners were not in the dark about Enron.

Under SAS No. 82 (AU §§316, 110), the Andersen Partners were required to apply greater skepticism to Enron's financial statements than would otherwise be required. ¶¶921-923. Instead, they turned a blind eye to Enron's numerous red flags and continued to issue purportedly clean audit opinions. ¶926. Their disregard of "'multiple red flags" could reasonably support an inference that [they] acted with intent.'" *MicroStrategy*, 115 F. Supp. 2d at 654.

7. The Andersen Partners Were Motivated to Defraud

Plaintiffs' motive allegations "meaningfully enhance" the inference of scienter against the Andersen Partners. *Zonagen*, 267 F.3d at 412; *BMC*, 183 F. Supp. 2d at 900. Enron was Andersen's second most lucrative client and in 00 alone paid the firm $27 million in consulting fees. ¶906. Andersen partners received extra units – worth about $200,000 per year – for selling consulting services. ¶907. By continuing to certify its fraudulent financial statements, the Andersen Partners expected this fee level – and their corresponding incomes – to surge. ¶906. The allure of substantial consulting fees motivated the Andersen Partners to commit fraud.

Their motivation is captured in the 2/5/01 conference call. Bauer, Bennett, Goddard, Goolsby, Jones, Lowther, Odom, Stewart, and Swanson expressly discussed the crucial problems with Enron's accounting; they questioned Enron's aggressive structuring of off-balance sheet transactions; they examined the conflict of interest posed by Fastow's dual position as Enron's CFO and LJM fund manager; they expressed concern over Enron's absolute dependence on its credit rating to remain solvent; and they characterized Enron's mark-to-market accounting as mere "intelligent gambling." ¶930. They nonetheless agreed to issue an unqualified audit opinion less than three weeks later. ¶903. The reason: "[I]t would not be unforeseeable that fees could reach a $100 million per year amount considering the multi-disciplinary services being provided [to Enron]." ¶912. These motive allegations raise a strong inference of scienter. *Complete Mgmt.*, 153 F. Supp. 2d at 335; *MicroStrategy*, 115 F. Supp. 2d at 656.

In a related context, Judge Easterbrook rejected an argument from a large accounting firm that its auditor would never participate in a fraud to collect just $25,000 in fees:

> Why, it asks, would it help Powers hoodwink investors? For the 1983 audit Peat Marwick collected less than $25,000. It would be insane to facilitate a securities fraud, and expose itself to huge liabilities, in exchange for this paltry sum, Peat Marwick insists, adding that when in the course of the 1984 audit it got a whiff of fraud it immediately withdrew. Maybe so, but the state of mind of the local auditors is imputed to the partnership, and one of the auditors in Oklahoma may have been trying to boost Pepco in the hope of enlarging the stream of revenues in future years.

Frymire-Brinati v. KPMG Peat Marwick, 2 F.3d 183, 191 (7th Cir. 1993). *Accord CFS-Related Sec. Fraud Litig.*, No. 99-CV-825-K(J), Report and Recommendation Regarding Those Claims Pled Against Arthur Andersen at 6 (N.D. Okla. Dec. 21, 2001) ("An individual [auditor] certainly may have a motive to obtain and keep a large client such as CFS. It is, therefore, not outside the realm of possibilities that a partner, in his desire to keep a large client, could choose to ignore facts of which he is aware, or in his zeal to give the client what it wants, recklessly ignore facts."), *adopted sub nom. MPF Ltd. v. Bartmann*, No. 99-CV-829-K(J), slip op. at 4-7 (N.D. Okla. Mar. 28, 2002).[14]

Neither *Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994), nor *BMC*, 183 F. Supp. 2d at 860, foreclose plaintiffs' motive allegations. *Melder* disallowed allegations based on an accountant's

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[14] Due to the length of this opinion, it is not being attached to this brief.

motivation to preserve and increase its auditing fees. *Id.* at 1103. Similarly, *BMC* merely recognized that "motives possessed by nearly all corporate insiders" are insufficient. 183 F. Supp. 2d at 896. Here, plaintiffs have "alleged more than just a desire to receive compensation for professional auditing duties on the part of" Andersen. *MicroStrategy*, 115 F. Supp. 2d at 655.

The Andersen Partners also contend that the motive allegations are not particularized. The CC explicitly alleges Andersen partners received extra units based on the non-auditing services they sold. ¶907. Thus, while plaintiffs do not allege the specific amount that each Andersen Partner received, plaintiffs sufficiently allege that each partner was motivated by the compensation plan that applied to all of them. *Id.*

V. PLAINTIFFS ALLEGE CONTROL PERSON VIOLATIONS AGAINST THE ANDERSEN PARTNERS

Plaintiffs also plead control person liability against the Andersen Partners. "Although worded in different ways, the control person liability provisions of §15 of the 1933 Securities Act and §20(a) of the 1934 Exchange Act are interpreted the same way." *BMC*, 183 F. Supp. 2d at 867 n.17. In this Court, the plaintiff "need only show that the alleged control persons possessed 'the power to control [the primary violator], not the exercise of the power to control.'" *Id.* Even indirect means of influence or control short of actual direction suffices. *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957 (5th Cir. 1981). And "whether a defendant is a control person is usually a question of fact." *Landry's*, slip op. at 12 n.14.

As shown in the Andersen Opposition, plaintiffs have pled violations of §11 of the 1933 Act, §10(b) of the 1934 Act, and Rule 10b-5 against Andersen. The detailed allegations in the CC also show that the Andersen Partners controlled Andersen.

The Andersen Partners contend they did not control the Enron audits. This is absurd. The Andersen Partners comprised the Enron engagement and audit team. ¶93. The decision to certify Enron's financial statements on Andersen's behalf rested with them. Under these circumstances, it is clear the Andersen Partners "possessed the power to direct or cause the direction of the management" of Andersen and had "the power to influence and control" its actions. *Landry's*, slip op. at 12 n.14.

Although not necessary to plead control person liability, plaintiffs also detail the Andersen Partners' "direct participation in the scheme through wrongful acts." *Landry's*, slip op. at 65. Tom Bauer, for example, was a partner on the Enron engagement team, ran the audit of Enron's commodity trading, and presented the results of the engagement team's 98 audit to the Enron Audit Committee. ¶93(b); Ex. 17. Bauer structured Chewco and knew Enron was controlling it through Kopper, a nominal investor. ¶¶942, 943, 946; Bauer Congressional Testimony. He was notified of Bass' objections to Enron SPE transactions and attended the 2/5/01 conference call during which Andersen partners discussed Enron's serious accounting irregularities. ¶¶929-931. When the Enron fraud was unraveling, Bauer convened a meeting to stress the need to bring Andersen's Enron files into "compliance" and then destroyed documents himself as well as instructed Michael Jones to destroy Enron documents in London. ¶¶93(q), 966. These allegations demonstrate Bauer's participation and control over most facets of Andersen's involvement in the Enron fraud.

Debra Cash headed Andersen Houston's lucrative energy practice, was deeply involved in the structuring of the LJM partnerships and the Raptor vehicles, and was integral to the Enron audits. ¶¶93(d), 950, 952; 5/29/02 Trial Tr. at 4918:16-25; Ex. 15. Like Bauer, she received copies of Bass' e-mails that criticized the Raptors and other Enron SPEs. ¶¶950, 952. Cash attended the emergency meeting convened to determine how to cope with the Sherron Watkins revelations, and thus had control over the decision whether to withdraw the false audit opinions for 97-00. ¶933. She was instrumental in the destruction of Andersen's Enron-related documents. Jonathan Weil, "Enron's Auditors Debated Parternship Losses," *Wall St. J.*, 4/30/02.

Steve Goddard was the managing partner of Andersen's Houston office, led the Audit and Business Advisory Energy Practice, and participated significantly in the Enron audits. ¶93(g). He presented the engagement team's 98 audit opinion to the Enron Audit Committee and was present when Duncan told the Audit Committee that Enron's SPEs had a "a high 'others could have a different view' risk profile." Ex. 17. Goddard attended the 2/5/01 client-retention conference call to discuss CFO Fastow's conflicts of interest, Enron's aggressive structuring of off-balance sheet transactions, the impact of LJM partnerships to Enron's financial statements, and Enron's affinity for using mark-to-market accounting–or "intelligent gambling." ¶930. Goddard and the other attendees

agreed to issue a clean audit opinion, notwithstanding Enron's severe accounting problems, because they believed Enron could turn into a $100 million a year client. ¶¶931, 933. These allegations against Bauer, Cash, and Goddard "show ... 'the power to control'" the Enron audit and Andersen's relationship with Enron. *BMC*, 183 F. Supp. 2d at 867 n.17.

The control person allegations against the other Andersen Partners are just as strong. Gary Goolsby, an Andersen Houston partner, oversaw the Enron audit team. ¶¶93(h), 978. He too attended the 2/5/01 conference call and determined to issue a clean audit opinion though Enron was committing significant accounting fraud. ¶930. Lowther was the concurring partner on the fraudulent Enron audits and was charged with determining the engagement risks Enron posed. ¶93(i); Ex. 19. He attended the 2/5/01 conference call, was deeply involved in the decisions to allow Enron improperly to avoid impairment charges for the Raptor transactions and to approve the LJM transactions, and participated in the emergency meeting precipitated by the Watkins disclosures. ¶¶930, 952, Odom Deposition Tr. at 67-81.

Michael Odom served as the audit practice director for Andersen's Gulf Coast Market Circle, played an integral part in the Enron audit, and helped to remove Carl Bass from his oversight position. ¶93(k). Odom attended the 2/5/01 meeting, wherein he and other Andersen partners agreed to retain Enron as a client and issue a clean audit opinion for 00, despite identifying numerous accounting irregularities by Enron. ¶¶930-931. Testimony and e-mail reveal that Odom was deeply involved in accounting for the Raptor transactions and knew that Bass, as well as other members of the PSG, thought Enron's accounting for the Raptors was deceptive. ¶952; 5/28/02 Trial Tr. at 4726:2-10; Odom Deposition Tr. at 71:2-8. And Odom was instrumental in instructing Duncan to "comply" with Andersen's purported document retention plan. ¶966.

Ben Neuhausen was a partner in Andersen's Chicago Business Unit, received correspondence from Carl Bass detailing severe problems with Enron's accounting, and participated in the Enron audits. ¶¶93(j), 928-929. On 12/18/99, Bass e-mailed Neuhausen to condemn Enron's accounting treatment for an SPE. ¶928. On 2/1/00, Bass warned Neuhausen that several Enron SPE transaction "look[ed] like there is no substance" to them. ¶929. Neuhausen was heavily involved in structuring

the LJM partnerships, the decisions to permit Enron improperly to account for LJM2, and approved Enron's abuse of mark-to-market accounting. ¶¶940, 950.

John Stewart was a senior audit specialist in Andersen's Chicago headquarters and performed substantial work on the Enron audits. ¶93(m). Stewart received several e-mails from Bass criticizing Enron's accounting irregularities for SPE transactions including the Raptors. ¶¶928-929, 952. Stewart played a crucial role in structuring the LJM entities and the decisions to allow Enron to misaccount for LJM2. ¶950; Ex. 15. He attended the 2/5/01 client-retention meeting and agreed to issue a false audit opinion of Enron for 00. ¶¶930-931. Just before Enron released its 00 10-K, Bass sent another e-mail to Stewart expressing his outrage with Enron's accounting for the Braveheart deal and Raptor transactions. ¶932. Stewart still allowed Enron's 10-K to include an unqualified audit opinion. Stewart attempted to conceal his and Andersen's willing participation in the Enron fraud by adding to memoranda Bass' previously-omitted criticisms. ¶966.

Roger Willard was a partner on the Enron engagement, was a member of Andersen's Audit and Business Advisory practice in Houston, and played an important role in the Enron audits. ¶93(p). Willard formulated the accounting treatment of the Braveheart transaction and knew that Bass disapproved of it. 5/30/02 Trial Tr. at 5394:5-19. Willard also held a meeting with his managers and staff to ensure "compliance" with Andersen's document retention policy. ¶966. These allegations are more than sufficient to plead a *prima facie* case of control person liability. *See Landry's*, slip op. at 12 n.14.

William Swanson was the Audit Division Head for the Gulf Coast Market Circle and oversaw the Enron audit. ¶93(o). He attended the 2/5/01 conference call and allowed a clean audit opinion to be issued in spite of Enron's known accounting deceptions. ¶¶930-931. Swanson participated in the 8/21/01 emergency meeting to discuss the Watkins revelations and for three months allowed the false Enron audit opinions for 97-00 to linger in the marketplace. ¶933.

Partners Michael Bennett and Michael Jones also participated in the 2/5/01 client retention call and approved the release of an unqualified opinion of Enron's financial statements though they knew Enron was engaging in improper accounting practices. ¶¶93(n), 93(q), 930-931, 938. Jones also destroyed Enron-related documents. ¶93(q). Richard Petersen was a partner in the PSG group,

knew of Bass' vociferous objections to Enron's accounting practices, and approved of Enron's abusive mark-to-market practices. ¶¶93(l), 940. Defendants Temple, Dreyfuss, and Friedlieb ordered Enron-related documents destroyed to hide Andersen's role in the Enron fraud, but delayed warning the investing public about the fraud. ¶¶93(e)-(f), 95, 965-966. Temple also knew of the Watkins revelations in 8/01. ¶95. Partner Gregory Hale played an important role in the Enron audits. ¶93(r). These allegations are also sufficient. *See Landry's*, slip op. at 65.[15]

The allegations against Chairman Berardino state a claim for control person liability as well. ¶96. Berardino conversed with Duncan and other senior Enron engagement partners on a regular basis, keeping informed of the accounting practices at Enron – Andersen's second largest client. ¶93(a). He met with Enron Chief Accounting Officer Richard Causey to discuss Bass' objections to Enron's accounting practices. *Id.* Berardino and other senior partners removed Bass based on Causey's demands, facilitating the continuation of the fraud. *Id.* Berardino, moreover, knew of the massive document destruction by Andersen. ¶966. The removal of Bass and his complicity in the document destruction illustrate the substantial control Berardino wielded over the Enron audit. *See Landry's*, slip op. at 12 n.14. The removal also sent a message to other Andersen auditors working on the Enron engagement which contributed to the enormous audit failure: pleasing the client is more important than fulfilling professional responsibilities with respect to objectivity and skepticism.

Bernardino suggests he was detached from the Enron engagement. Bass' removal and his complicity in deliberate document destruction belie this claim. ¶¶913, 966. Nor do *Cameron v. Outdoor Resorts of Am., Inc.*, 608 F.2d 187 (5th Cir. 1979) and *Paracor Fin. v. GE Capital Corp.*, 96 F.3d 1151 (9th Cir. 1996), support dismissing the control person allegations against him. In *Cameron*, the Fifth Circuit upheld ***a finding of fact*** that a director acted in good faith. 608 F.2d at 195. Similarly, in *Paracor*, the defendant CEO was found not to be a control person at the summary judgment stage of the proceeding. 96 F.3d at 1163.[16]

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[15] Plaintiffs have agreed to dismiss without prejudice Danny Rudloff and John Sorrells.

[16] Michael Jones also moves to dismiss on grounds of defective service. If the Court finds that service on defendant Jones was not proper, plaintiffs will go through any steps this Court requests. Plaintiffs are currently attempting to serve Jones through the procedures of the Hague Convention.

VI. CONCLUSION

For the reasons set forth above, the motion of the Individual Andersen Defendants to Dismiss Count I of plaintiffs' CC, as well as Michael C. Odom's Motion to Dismiss, should be denied in their entirety.

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Respectfully submitted,

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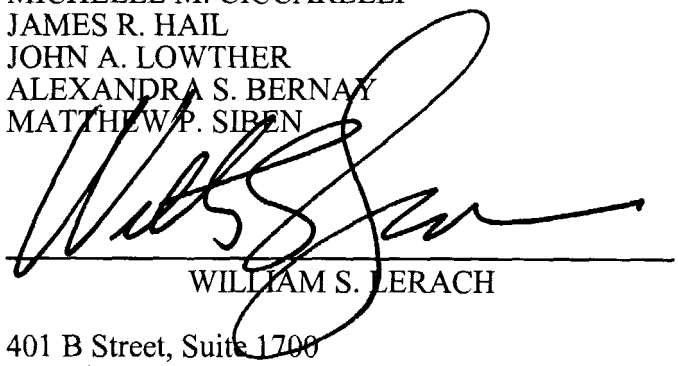

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